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CASES AND MATERIALS

ON

FEDERAL TAXATION

FIFTH EDITION

By

ERWIN N. GRISWOLD

Dean and Langdell Professor of Law

Harvard Law School

Brooklyn

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PREFACE

The first edition of this case book appeared twenty years ago. At that time, the problem was to find a publisher, because there seemed to be real doubt that there would be sufficient law school demand for a course devoted exclusively to Federal Taxation. Indeed, a publisher was found only due to the active support of Professor Edmund M. Morgan, the Directing Editor of the University Casebook Series.

The first edition had 744 pages, and proceeded at a rather leisurely pace. The statute was relatively simple, and many of the problems were essentially "common law" in nature. In the intervening years, the statute has become much longer and more complex, and a much higher proportion of the problems turns on the application and construction of often intricate statutory provisions. The volume of case law has increased many fold.

In this situation, the task of the case book editor has become more difficult, even as the problem of the student has been considerably increased. Nevertheless, a determined effort has been made to hold down the length of the book. This edition of the case book is 50 per cent longer than the one put out twenty years ago, but it is only 88 pages longer than the fourth edition, published in 1954–55. No effort has been made to provide a book which is in any sense encyclopedic. On the contrary, the purpose in preparing the book has been to provide the means through which an instructor can conduct a basic course in all the branches of Federal Taxation.

With few exceptions, provisions of the statute are not reprinted in this book. It is assumed that the book will be supplemented with adequate statutory material. In addition to the case book, the student should provide himself with a copy of the current edition of the Internal Revenue Code, and of the Income Taxation Regulations, Estate Tax Regulations, and Gift Tax Regulations, or with a suitable Service which provides equivalent material.

Although it is now six years since the Internal Revenue Code of 1954 was enacted, there are still very few court decisions under that Code. Most of the cases in this book, therefore, deal with the 1939 Code. It would be cumbersome to point out in connection with each case in the case book that the current statutory references are different, and this has not been done, with few exceptions. Nevertheless, the student will always have to keep in mind the fact that the statutory references in the cases he reads, and often their application, are changed in the 1954 Code. To aid

in this process, a comprehensive Table of Cross References from the 1939 to the 1954 Codes is included at the close of this book, immediately preceding the Index.

In reproducing court decisions and rulings, footnotes have been freely omitted, without indication of the omission, and footnotes have in some cases been renumbered.

In the preparation of this new edition, I have received many comments and suggestions from fellow law teachers. These have been very helpful, and are gratefully acknowledged here. Particular thanks are due to Dean Henry Brandis, of the University of North Carolina Law School, to Professor Mortimer M. Caplin of the University of Virginia Law School, and to Professor Sam D. Thurman, of the Stanford University Law School. In addition, I want to express my thanks to Miss Janet Murphy and to Miss Karen Disbrow, who have helped efficiently with the sometimes arduous task of putting the book together and bringing it to completion.

ERWIN N. GRISWOLD

Harvard Law School
Cambridge, Massachusetts
July, 1960

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CASES ON FEDERAL TAXATION

CHAPTER 1

BACKGROUND

A. CONSTITUTIONAL PROVISIONS

Article I, Section 2, clause 3:

"Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons." [1]

Article I, Section 7, clause 1:

"All Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills."

Article I, Section 8, clause 1:

"The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States."

Article I, Section 9, clauses 4 and 5:

"No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

"No Tax or Duty shall be laid on Articles exported from any State."

Article I, Section 10, clauses 2 and 3:

"No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be

[1] The part of this clause relating to the method of apportionment was amended by the Fourteenth Amendment, clause 2, and as to taxes on income by the Sixteenth Amendment, which is quoted below.

absolutely necessary for executing its inspection Laws: and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States; and all such Laws shall be subject to the Revision and Controul of the Congress.

"No State shall, without the Consent of Congress, lay any Duty of Tonnage, . . ."

Fifth Amendment:

"No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." [2]

Tenth Amendment:

"The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively or to the people."

Sixteenth Amendment: [3]

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

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2 The Fourteenth Amendment, Section 1, which became effective in 1868, includes the following provision: "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

3 The Sixteenth Amendment was submitted to the legislatures of the several States by a joint resolution of Congress passed on July 12, 1909, 36 Stat. 184. Ratification by the required number of States was completed early in February, 1913, and this was proclaimed by the Secretary of State on February 25, 1913, 37 Stat. 1785. The States of Connecticut, Rhode Island, and Utah rejected this amendment.

The history of the Sixteenth Amendment is carefully treated in Part II of Taxation of Government Bond-Holders and Employees (1938), a study made by the Department of Justice, including an exhaustive documentary appendix.

B. HISTORICAL SUMMARY [1]

1. Since the days of the first administration, Congress has sought revenue from internal sources. The Act of March 3, 1791, imposed taxes on distilled spirits and carriages.[2] The former resulted in the "Whiskey Rebellion" in western Pennsylvania in 1794; [3] the latter, in the first Supreme Court case to consider the validity of an exercise of the taxing power. (See *Hylton v. United States, infra,* p. 22.) Snuff, sugar, legal instruments and bonds were subsequently subjected to tax, and, on July 9, 1798, a direct tax was imposed on real property. The first year's receipts (fiscal year 1792)[4] from internal revenue netted the Government $208,942.81. The first "Commissioner of the Revenue" was appointed on May 8, 1792, at a salary of $1,900 a year.

All internal revenue taxes, except a tax on salt, were abolished by the Act of April 6, 1802. The receipts from internal revenue during the period of a little more than ten years aggregated $6,-758,764.26. (In the fiscal year 1959, internal revenue collections were $79,797,973,000[5] or more than thirty-two times as much per day as the first tax bureau collected in ten years.)

2. The War of 1812 again made it necessary to supplement the financing of government affairs through internal taxes. The Act of July 24, 1813, levied taxes on refined sugar, carriages, distillers, and sales at auction. Acts passed during the next two

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1 This section obviously has no pretensions. It is based on a pamphlet "History of the Internal Revenue Service, 1791–1929," prepared under the direction of the Commissioner of Internal Revenue, and published by the Government Printing Office in 1930.

The history and the problems of federal taxation are treated with great skill and clarity in Paul, Taxation in the United States (1954).

See also Schmeckebier and Eble, The Bureau of Internal Revenue, Its History, Activities, and Organization (Brookings Institute Service Monograph No. 25) (1923); Blough, "The Evolution of the Federal Tax System," 7 Law and Contemporary Problems 162 (1940); Blakey, The Federal Income Tax (1940); Ratner, American Taxation, Its History as a Social Force (1942); Paul, Taxation for Prosperity (1947); Studenski and Kroos, Financial History of the United States (1952).

2 These taxes were proposed by Hamilton, and were intended "more as a measure of social discipline than as a source of revenue." 1 Morison, Oxford History of the United States 182 (1927).

3 The ultimate outcome of this episode was to demonstrate that the federal government could enforce its revenue laws. See 5 Dictionary of American History 457 (1940).

4 Federal appropriations and accounting are now in terms of fiscal years ending on June 30. When it is said that the federal revenue, or the receipts from a particular tax, were so much for a specified year, the twelve months ending on June 30 of the year indicated is now meant. This practice began in 1843. Prior to that time calendar years were used in federal finance. See Katz, "The Federal Fiscal Year: Its Origin and Prospects," 12 Nat.Tax J. 346 (1959).

5 See Annual Report of the Commissioner of Internal Revenue, Fiscal Year Ended June 30, 1958, p. 3.

years extended the taxable subjects considerably. All of the taxes were abolished by the Act of December 23, 1817. The total receipts during the five fiscal years these taxes were in effect were $25,833,449.43. This was the end of internal revenue taxation until the Civil War period. During the interim the government relied primarily upon revenues derived from customs duties and the sale of public lands.

3. On August 5, 1861, Congress provided for a direct tax on land, apportioned among the States. The collection of this tax covered a long period of years; the last collection was not made until 1888. The total amount collected was $15,387,233.76. By the Act of March 2, 1891, all of the money collected was returned to the States.

The Internal Revenue Bureau was re-established by the Act of July 1, 1862, which was sweeping in its scope. Taxes were imposed on a great variety of subjects and events. Many of these were collected by means of stamps, but there was also a tax on incomes in excess of $600 and an inheritance tax. The income tax was re-enacted at increased rates in 1864, and was sustained against contentions that it was a direct tax in *Springer v. United States, infra,* p. 30. On January 1, 1863, the Bureau had a force of 3,882 employees. Of these, however, only 60 were employed in Washington. The organization of the Internal Revenue Service as the result of the Act of July 1, 1862, was similar in general principle, although not in detail, to that in effect today.

The internal revenue collections for the fiscal year 1866 were the greatest of any year during the Civil War period. They totaled $310,120,448.13. In 1866 and 1867 Congress reduced many of the taxes. The internal revenue system which was to predominate for the next 45 years took shape in the Act of July 20, 1868, which was devoted entirely to distilled spirits and tobacco. This statute developed the taxes on liquor and tobacco in much the same form as that under which they are enforced at present. For the fiscal years 1868–1913, inclusive, the total internal revenue collections were $8,367,105,168.16. Of this amount, $7,468,100,996.69, or 89.3 per cent, represented collections on distilled spirits, tobacco, and fermented liquors.

4. After a bitter political struggle the Wilson Tariff Act of 1894 was passed, reducing the tariff rates, but reinstating the income tax which had been repealed in 1872. The Act of January 25, 1895, appropriated $245,000 to defray the expenses of collecting the income tax, and an income tax division was organized in the Bureau of Internal Revenue. On April 8, 1895, the work of this division was interrupted by a decision of the Supreme Court of the United States to the effect that the provisions of the law taxing incomes derived from real estate and from State and municipal bonds were unconstitutional. Upon a rehearing by the

Supreme Court, it was decided finally on May 20, 1895, that the whole income tax law was unconstitutional, on the ground that it was in too large part a direct tax and not apportioned among the States in conformity with the Constitution (see *Pollock v. Farmers Loan & Trust Co., infra,* p. 33).

The Spanish-American War again made it necessary for Congress to impose increased taxes. Among the taxes introduced was one on legacies, the constitutionality of which was upheld in *Knowlton v. Moore, infra,* p. 40. Under this legislation the revenue reached a total of $306,871,669.42 for the year 1901. Practically all of the Spanish-American War taxes were repealed by the Act of April 12, 1902.

5. In the Tariff Act of 1909, Congress imposed a tax measured by one per cent of corporate net incomes in excess of $5,000, which the Supreme Court upheld in *Flint v. Stone Tracy Co.,* 220 U.S. 107 (1911). The *Pollock* case was distinguished on the ground that the tax of 1909 was a corporate excise tax, that is, a tax on the privilege of being a corporation, rather than a tax on property, and thus not a direct tax. This corporation tax remained in effect until 1913, and was the forerunner of the general income tax.

6. The Sixteenth Amendment to the Constitution became effective on February 25, 1913. On October 3, 1913, Congress enacted a law which imposed a tax on the net income of both individuals and corporations, effective from March 1, 1913. The tax was upheld in *Brushaber v. Union Pacific R. R., infra,* p. 44. It was developed and extended in the Revenue Act of 1916, which also imposed an estate tax, effective September 8, 1916. A gift tax was passed for the first time in 1924; it was repealed in 1926, and reinstated in 1932. Its constitutionality was upheld in *Bromley v. McCaughn,* cited *infra,* p. 964.

The average internal revenue collections for the 12 years preceding 1915 were $281,084,239.60 a year. The average collections for the 12 years 1915–26, inclusive, were $2,777,113,074.45. In 1914, the Internal Revenue Service had 3,972 employees. In 1922 the number had risen to 21,388. (In the fiscal year 1959 there were 50,200 internal revenue employees.)

C. PRESENT FEDERAL TAXES

1. Internal Revenue

All internal revenue taxes are now imposed by the Internal Revenue Code of 1954, which became law on August 16, 1954. This is a complete revision of the Internal Revenue Code which was enacted on February 10, 1939, when for the first time all federal taxing provisions were brought together into one statute.

More than fifty different kinds of federal taxes are found in these Codes. These include taxes on incomes, estates, gifts, capital stock, excess profits, admissions, club dues, documents, playing cards, safe deposit boxes, circulation of bank notes,[1] cotton futures, tobacco, snuff and cigarettes, oleomargarine, filled cheese, mixed flour, oils, narcotics, white phosphorous matches, firearms, liquor, taxes on the manufacture of many articles, including tires, tubes, toilet preparations, automobiles, radios, refrigerators, matches, electrical energy, gasoline and lubricating oil, and taxes on transportation of oil by pipe line, and on telegraph, telephone, radio, and cable messages.

Many of these raise few questions and less litigation. Some of them, such as taxes on tobacco, liquor, and playing cards, are collected almost automatically, since the number of actual taxpayers is small and the taxable subjects are very clear.[2] Whatever may be regarded as the economic merits of these taxes, they certainly meet the test of raising large sums efficiently. The questions arising under these taxes are so few that no material with respect to them is presented in this book. The chief questions in federal tax practice arise with respect to the income tax; the estate and gifts taxes are next in volume of controversy, with other miscellaneous taxes contributing to the grist.

Some comparative figures of federal receipts and expenditures are given in the following table: [3]

		Internal Revenue			
Year	Customs	Income and Profits Taxes	Other	Net Receipts [4]	Total Expenditures
1800	$ 9,080,933	. . .	$ 809,396	$ 10,848,749	$ 10,786,075
1870	194,538,374	$ 37,775,874	147,123,882	411,255,477	309,653,561
1900	233,164,871	. . .	295,327,927	567,240,852	520,860,847
1920	322,902,650	3,944,949,288	1,460,082,287	6,694,565,389	6,403,343,841
1930	587,000,903	2,410,986,978	628,308,036	4,177,941,702	3,440,268,884
1940	348,590,636	2,125,324,635	3,177,809,353	5,264,663,044	9,182,682,204
1945	354,775,542	35,173,051,373	8,728,950,555	44,761,609,047	98,702,525,172
1950	422,650,329	28,262,671,097	11,185,936,012	37,044,733,557	40,166,835,915
1954	562,020,618	53,905,570,964	16,394,080,557	64,655,386,989	67,772,353,245
1959	948,412,215	58,826,253,507	20,971,719,301	68,270,252,715	80,697,239,466

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1 This was the tax which was sustained in Veazie Bank v. Fenno, 8 Wall. 533 (U.S.1869). Naturally it produces no revenue, its purpose being prohibitive. This is true of a number of the other taxes. Others, such as those on narcotics and firearms, are chiefly regulatory in purpose. See section F. pp. 49–68, infra.

2 A case arising under the tobacco tax is Liggett & Myers Tobacco Co. v. United States, 299 U.S. 383 (1937), noted in 35 Mich.L.Rev. 1027 (1937), where it was unsuccessfully contended that the tax could not be applied with respect to tobacco sold to a state for use in one of its hospitals.

3 See Annual Report of the Secretary of the Treasury for the Fiscal Year Ended June 30, 1959, pp. 368–373.

4 "Net receipts" equals total receipts less (a) appropriations to Federal old age and survivorship insurance trust fund beginning with the fiscal year 1937, and (b) refunds of receipts beginning with the fiscal year 1931.

2. Customs Duties

The first federal statute enacted at the opening of the first Congress, after one providing for the administration of the oath to members of the House and Senate, was an "Act for laying a Duty on Goods, Wares, and Merchandises imported into the United States," approved July 4, 1789, c. 2, 1 Stat. 24. For more than a century duties laid on imports provided by far the largest part of the total federal revenue, and they are still a very important part of the federal tax pattern. In the twenty years from 1925 through 1944, an average of $422,000,000 a year was raised from customs duties. In the year 1959, customs duty collections totaled $948,412,215, while internal revenue receipts, including social security taxes, were $79,797,972,808.

Customs duties are today imposed by separate statutes; they are handled by a separate group of officers in the Treasury; litigation is in a special group of customs tribunals, and is handled, on the whole, by a small and specialized section of the bar.[5] The separate customs tribunals find their origin in the Tariff Act of 1890, sec. 12, 26 Stat. 136, which established the Board of General Appraisers. In the course of time, this has metamorphosed into the United States Customs Court. See the Act of May 28, 1926, c. 411, 44 Stat. 669, now found in Title 28, United States Code, secs. 251–255. Congress has now expressly provided that the Customs Court is a constitutional court "established under Article III of the Constitution."[6]

Decisions of the Customs Court are reviewed by the United States Court of Customs and Patent Appeals, pursuant to the provisions of Title 28, United States Code, sec. 1541. Final review may be had in the Supreme Court, but only on writs of certiorari; these are very rarely granted, and in recent years, never except to consider constitutional questions, or matters of wide general interest. See *United States v. George S. Bush & Co.*, 310 U.S. 371 (1940); *Barr v. United States*, 324 U.S. 83 (1945).

J. W. HAMPTON, JR., & CO. v. UNITED STATES

Supreme Court of the United States, 1928. 276 U.S. 394.

MR. CHIEF JUSTICE TAFT delivered the opinion of the Court.

J. W. Hampton, Jr., & Company made an importation into New York of barium dioxide, which the collector of customs assessed at the dutiable rate of six cents per pound. This was two cents per pound more than that fixed by statute, par. 12, ch. 356, 42

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[5] See Futrell, The History of American Customs Jurisprudence (1941).

[6] Act of July 14, 1956, c. 589, sec. 1, 70 Stat. 532.

Stat. 858, 860. The rate was raised by the collector by virtue of the proclamation of the President, 45 Treas.Dec. 669, T.D. 40216, issued under, and by authority of, Section 315 of Title III of the Tariff Act of September 21, 1922, ch. 356, 42 Stat. 858, 941, which is the so-called flexible tariff provision. Protest was made and an appeal was taken under Section 514, Part 3, Title IV, ch. 356, 42 Stat. 969–70. The case came on for hearing before the United States Customs Court, 49 Treas.Dec. 593. A majority held the Act constitutional. Thereafter the case was appealed to the United States Court of Customs Appeals. . . . Thereafter the judgment of the United States Customs Court was affirmed. 14 Ct.Cust.App. 350. On a petition to this Court for certiorari, filed May 10, 1927, the writ was granted, 274 U.S. 735. The pertinent parts of Section 315 of Title III of the Tariff Act, ch. 356, 42 Stat. 858, 941 U.S.C., Tit. 19, Sections 154, 156, are as follows:

"Section 315(a). That in order to regulate the foreign commerce of the United States and to put into force and effect the policy of the Congress by this Act intended, whenever the President, upon investigation of the differences in costs of production of articles wholly or in part the growth or product of the United States and of like or similar articles wholly or in part the growth or product of competing foreign countries, shall find it thereby shown that the duties fixed in this Act do not equalize the said differences in costs of production in the United States and the principal competing country he shall, by such investigation, ascertain said differences and determine and proclaim the changes in classifications or increases or decreases in any rate of duty provided in this Act shown by said ascertained differences in such costs of production necessary to equalize the same. Thirty days after the date of such proclamation or proclamations, such changes in classification shall take effect, and such increased or decreased duties shall be levied, collected, and paid on such articles when imported from any foreign country into the United States or into any of its possessions (except the Philippine Islands, the Virgin Islands, and the islands of Guam and Tutuila): *Provided,* That the total increase or decrease of such rates of duty shall not exceed 50 per centum of the rates specified in Title I of this Act, or in any amendatory Act. . . .

"(c). That in ascertaining the differences in costs of production, under the provisions of subdivisions (a) and (b) of this section, the President, in so far as he finds it practicable, shall take into consideration (1) the differences in conditions in production, including wages, costs of material, and other items in costs of production of such or similar articles in the United States and in competing foreign countries; (2) the differences in the wholesale selling prices of domestic and foreign articles in

the principal markets of the United States; (3) advantages granted to a foreign producer by a foreign government, or by a person, partnership, corporation, or association in a foreign country; and (4) any other advantages or disadvantages in competition.

"Investigations to assist the President in ascertaining differences in costs of production under this section shall be made by the United States Tariff Commission, and no proclamation shall be issued under this section until such investigation shall have been made. The commission shall give reasonable opportunity to parties interested to be present, to produce evidence, and to be heard. The commission is authorized to adopt such reasonable procedure, rules, and regulations as it may deem necessary. The President, proceeding as hereinbefore provided for in proclaiming rates of duty, shall, when he determines that it is shown that the differences in costs of production have changed or no longer exist which led to such proclamation, accordingly as so shown, modify or terminate the same. Nothing in this section shall be construed to authorize a transfer of an article from the dutiable list to the free list or from the free list to the dutiable list, nor a change in form of duty. Whenever it is provided in any paragraph of Title I of this Act, that the duty or duties shall not exceed a specified ad valorem rate upon the articles provided for in such paragraph, no rate determined under the provision of this section upon such articles shall exceed the maximum ad valorem rate so specified."

The President issued his proclamation May 19, 1924, [increasing the duty on barium dioxide to 6 cents a pound.]

The issue here is as to the constitutionality of section 315, upon which depends the authority for the proclamation of the President and for two of the six cents per pound duty collected from the petitioner. The contention of the taxpayers is two-fold—first, they argue that the section is invalid in that it is a delegation to the President of the legislative power, which by Article I, Section 1 of the Constitution, is vested in Congress, the power being that declared in Section 8 of Article I, that the Congress shall have power to lay and collect taxes, duties, imposts and excises. The second objection is that, as section 315 was enacted with the avowed intent and for the purpose of protecting the industries of the United States, it is invalid because the Constitution gives power to lay such taxes only for revenue.

First. . . . [1] It is conceded by counsel that Congress may use executive officers in the application and enforcement of a policy declared in law by Congress, and authorize such officers in the application of the Congressional declaration to enforce it

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[1] Most of the Court's discussion of delegation is omitted.

by regulation equivalent to law. But it is said that this never has been permitted to be done where Congress has exercised the power to levy taxes and fix customs duties. The authorities make no such distinction. The same principle that permits Congress to exercise its rate making power in interstate commerce, by declaring the rule which shall prevail in the legislative fixing of rates, and enables it to remit to a rate-making body created in accordance with its provisions the fixing of such rates, justifies a similar provision for the fixing of customs duties on imported merchandise. If Congress shall lay down by legislative act an intelligible principle to which the person or body authorized to fix such rates is directed to conform, such legislative action is not a forbidden delegation of legislative power. If it is thought wise to vary the customs duties according to changing conditions of production at home and abroad, it may authorize the Chief Executive to carry out this purpose, with the advisory assistance of a Tariff Commission appointed under Congressional authority. This conclusion is amply sustained by a case in which there was no advisory commission furnished the President—a case to which this Court gave the fullest consideration nearly forty years ago. . . . [2]

Second. The second objection to section 315 is that the declared plan of Congress, either expressly or by clear implication, formulates its rule to guide the President and his advisory Tariff Commission as one directed to a tariff system of production that will avoid damaging competition to the country's industries by the importation of goods from other countries at too low a rate to equalize foreign and domestic competition in the markets of the United States. It is contended that the only power of Congress in the levying of customs duties is to create revenue, and that it is unconstitutional to frame the customs duties with any other view than that of revenue raising. It undoubtedly is true that during the political life of this country there has been much discussion between parties as to the wisdom of the policy of protection, and we may go further and say as to its constitutionality, but no historian, whatever his view of the wisdom of the policy of protection, would contend that Congress, since the first revenue Act, in 1789, has not assumed that it was within its power in making provision for the collection of revenue, to put taxes upon importations and to vary the subjects of such taxes or rates in an effort to encourage the growth of the industries of the Nation by protecting home production against foreign competition. It is enough to point out that the second act adopted by the Congress of the United States, July 4, 1789, ch. 2, 1 Stat. 24, contained the following recital.

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[2] The Court here discussed Field v. Clark, 143 U.S. 649 (1892).

"Sec. 1. Whereas it is necessary for the support of government, for the discharge of the debts of the United States, and the encouragement and protection of manufacturers, that duties be laid on goods, wares and merchandises imported: Be it enacted, etc."

In this first Congress sat many members of the Constitutional Convention of 1787. This Court has repeatedly laid down the principle that a contemporaneous legislative exposition of the Constitution when the founders of our Government and framers of our Constitution were actively participating in public affairs, long acquiesced in, fixes the construction to be given its provisions. *Myers v. United States,* 272 U.S. 52, 175, and cases cited. The enactment and enforcement of a number of customs revenue laws drawn with a motive of maintaining a system of protection, since the revenue law of 1789, are matters of history.

More than a hundred years later, the titles of the Tariff Acts of 1897 and 1909 declared the purpose of those acts, among other things, to be that of encouraging the industries of the United States. The title of the Tariff Act of 1922, of which section 315 is a part, is "An Act to provide revenue, to regulate commerce with foreign countries, to encourage the industries of the United States and for other purposes." Whatever we may think of the wisdom of a protection policy, we can not hold it unconstitutional.

So long as the motive of Congress and the effect of its legislative action are to secure revenue for the benefit of the general government, the existence of other motives in the selection of the subject of taxes can not invalidate Congressional action. As we said in the *Child Labor Tax Case,* 259 U.S. 20, 38: "Taxes are occasionally imposed in the discretion of the legislature on proper subjects with the primary motive of obtaining revenue from them, and with the incidental motive of discouraging them by making their continuance onerous. They do not lose their character as taxes because of the incidental motive." And so here, the fact that Congress declares that one of its motives in fixing the rates of duty is so to fix them that they shall encourage the industries of this country in the competition with producers in other countries in the sale of goods in this country, can not invalidate a revenue act so framed. Section 315 and its provisions are within the power of Congress. The judgment of the Court of Customs Appeals is affirmed.

Affirmed.

BOARD OF TRUSTEES OF THE UNIVERSITY OF ILLINOIS v. UNITED STATES

Supreme Court of the United States, 1933. 289 U.S. 48.

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

The University of Illinois imported scientific apparatus for use in one of its educational departments. Customs duties were exacted at the rates prescribed by the Tariff Act of 1922, c. 356, 42 Stat. 858. The University paid under protest, insisting that as an instrumentality of the State of Illinois, and discharging a governmental function, it was entitled to import the articles duty free. At the hearing on the protest, the Customs Court decided in favor of the Government (59 Treas.Dec. 747) and the Court of Customs and Patent Appeals affirmed the decision. 61 Treas. Dec. 1334. This Court granted certiorari.

The Tariff Act of 1922 is entitled—"An Act to provide revenue, to regulate commerce with foreign countries, to encourage the industries of the United States, and for other purposes." The Congress thus asserted that it was exercising its constitutional authority "to regulate commerce with foreign nations." Art. I, Sec. 8, par. 3. The words of the Constitution "comprehend every species of commercial intercourse between the United States and foreign nations. No sort of trade can be carried on between this country and any other, to which this power does not extend." *Gibbons v. Ogden,* 9 Wheat. 1, 193. It is as essential attribute of the power that it is exclusive and plenary. As an exclusive power, its exercise may not be limited, qualified or impeded to any extent by state action. *Id.* pp. 196–200; *Brown v. Maryland,* 12 Wheat. 419, 446; *Almy v. California,* 24 How. 169, 173; *Buttfield v. Stranahan,* 192 U.S. 470, 492, 493. The power is buttressed by the express provision of the Constitution denying to the States authority to lay imposts or duties on imports or exports without the consent of the Congress. Art. I, Sec. 10, par. 2.

The Congress may determine what articles may be imported into this country and the terms upon which importation is permitted. No one can be said to have a vested right to carry on foreign commerce with the United States. *Buttfield v. Stranahan, supra; The Abby Dodge,* 223 U.S. 166, 176, 177; *Brolan v. United States,* 236 U.S. 216, 218, 219; *Weber v. Freed,* 239 U.S. 325, 329, 330. If the Congress saw fit to lay an embargo or to prohibit altogether the importation of specified articles, as the Congress may (*The Brigantine William,* 2 Hall's Amer.L.J., 255; Fed.Cas.No.16700; *Gibbons v. Ogden, supra,* pp. 192, 193; *Brolan v. United States, supra; Weber v. Freed, supra; Atlantic Cleaners & Dyers v. United States,* 286 U.S. 427, 434), no State by virtue

of any interest of its own would be entitled to override the restriction. The principle of duality in our system of government does not touch the authority of the Congress in the regulation of foreign commerce.

Appellant argues that the Tariff Act is a revenue measure; that it is not the less so because it is framed with a view, as its title states, of encouraging the industries of the United States (*Hampton & Co. v. United States,* 276 U.S. 394, 411, 412); that the duty is a tax, that the Act is not one for the regulation of commerce but is an exertion of the taxing power, and that, as such, it is subject to the constitutional limitation that the Congress may not lay a tax so as to impose a direct burden upon an instrumentality of a State used in the performance of a governmental function.

It is true that the taxing power is a distinct power; that it is distinct from the power to regulate commerce. *Gibbons v. Ogden, supra,* p. 201. It is also true that the taxing power embraces the power to lay duties. Art. I, Sec. 8, par. 1. But because the taxing power is a distinct power and embraces the power to lay duties, it does not follow that duties may not be imposed in the exercise of the power to regulate commerce. The contrary is well established. *Gibbons v. Ogden, supra,* p. 202. "Under the power to regulate foreign commerce Congress impose duties on importations, give drawbacks, pass embargo and non-intercourse laws, and make all other regulations necessary to navigation, to the safety of passengers, and the protection of property." *Groves v. Slaughter,* 15 Pet. 449, 505. The laying of duties is "a common means of executing the power." 2 Story on the Constitution, sec. 1088. It has not been questioned that this power may be exerted by laying duties "to countervail the regulations and restrictions of foreign nations." *Id.,* sec. 1087. And the Congress may, and undoubtedly does, in its tariff legislation consider the conditions of foreign trade in all its aspects and effects. Its requirements are not the less regulatory because they are not prohibitory or retaliatory. They embody the congressional conception of the extent to which regulation should go. But if the Congress may thus exercise the power, and asserts, as it has asserted here, that it is exercising it, the judicial department may not attempt in its own conception of policy to distribute the duties thus fixed by allocating some of them to the exercise of the admitted power to regulate commerce and others to an independent exercise of the taxing power. The purpose to regulate foreign commerce permeates the entire congressional plan. The revenue resulting from the duties "is an incident to such an exercise of the power. It flows from, but does not create the power." *Id.*

The principle invoked by the petitioner, of the immunity of state instrumentalities from federal taxation has its inherent limitations. *Fox Film Corp. v. Doyal,* 286 U.S. 123, 128. It is a principle implied from the necessity of maintaining our dual system of government. *Collector v. Day,* 11 Wall. 113, 127; *Willcuts v. Bunn,* 282 U.S. 216, 225; *Indian Motorcycle Co. v. United States,* 283 U.S. 570, 575. Springing from that necessity it does not extend beyond it. Protecting the functions of government in its proper province, the implication ceases when the boundary of that province is reached. The fact that the State in the performance of state functions may use imported articles does not mean that the importation is a function of the State government independent of federal power. The control of importation does not rest with the State but with the Congress. In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power. There is thus no violation of the principle which petitioner invokes, for there is no encroachment on the power of the State as none exists with respect to the subject over which the federal power has been exerted. To permit the States and their instrumentalities to import commodities for their own use, regardless of the requirements imposed by the Congress, would undermine, if not destroy, the single control which it was one of the dominant purposes of the Constitution to create. It is for the Congress to decide to what extent, if at all, the States and their instrumentalities shall be relieved of the payment of duties on imported articles.

The contention of the petitioner finds no support in the history of tariff acts or in departmental practice. It is not necessary to review this practical construction. It is sufficient to say that only in recent years has any question been raised by state officials as to the authority of Congress to impose duties upon their imports. . . .

Judgment affirmed.

D. THE MATERIALS OF FEDERAL TAXATION

1. STATUTES

The *first* matter to consider in *any* tax case is: What are the exact words of the statute? [1] There is no use in thinking great thoughts about a tax problem unless the thoughts are firmly based on the controlling statute. There is coming to be a significant amount of common law of federal taxation, but federal taxation is not a common law subject.

The basic statute is now the Internal Revenue Code of 1954, approved August 16, 1954. This supersedes the Internal Revenue Code, enacted February 10, 1939, which is the statute involved in most of the cases in this book. The new Internal Revenue Code of 1954, introduces many changes in the substance of the law. It also involves a very substantial rewriting and rearrangement of the statute, with a complete change of section numbers. A table of cross-references from the old to the new numbers is included at the close of this book.

Nearly all of the cases in this book involve tax years prior to the time when the new Code became effective. Therefore, the statutory references are to the provisions of the 1939 Code, or to provisions of earlier law. No effort has been made to indicate the corresponding provisions of the 1954 Code. These can be found from the cross reference table at the close of this volume. Moreover, the student will have to become familiar with the earlier references, both in understanding the case law which has grown up, and to which reference will be made for many years, and because many tax controversies now being handled in law offices involve 1953 and earlier years which are governed by the older law.

The earlier statutes are particularly important in showing the history and development of the provisions now contained in the Code, "the Government's endeavor to keep pace with the fertility of invention" [2] by taxpayer's lawyers. The first of the modern

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[1] In the first edition of this book, the heading to this section was presented in large capitals, as above. The editor was chided for this, however, by a reviewer; and so, with faint heart, he used ordinary type in the second edition. That was a mistake. Many students have said that they remembered that one word when they had forgotten most of the rest of the course. It is undoubtedly the most important word in the book.

[2] The phrase comes from Mr. Justice Cardozo, in Burnet v. Wells, 289 U. S. 670, 676 (1933).

statutes was the corporation tax provision in the Tariff Act of 1909, c. 6, 36 Stat. 11, 112. The first general income tax was included in the Tariff Act of 1913, c. 16, 38 Stat. 114, 166. There have followed a steady succession of revenue acts. Special reference may be made to the following:

Revenue Act of 1916, which introduced the modern estate tax.

Revenue Act of 1928—introduced a new system of arrangement and numbering in the income tax division, which was followed in later Acts and was carried into the 1939 Code.

Internal Revenue Code, of 1939—the basic law, with numerous amendments, from 1939 to 1954.

Public Salary Tax Act of 1939.

Second Revenue Act of 1940—the beginning of the World War II excess profits tax.

Revenue Act of 1942—the major war time tax law.

Current Tax Payment Act of 1943—enacted the so-called Ruml plan, or pay as you go method of tax collection, including withholding at the source on wages and salaries—included the "foregiveness" feature in changing the method of tax collection.

Revenue Act of 1945—repealed the excess profits tax at the end of 1945; reduced individual tax rates for 1946.

Revenue Act of 1948—introduced "split incomes" and the marital deduction.

Internal Revenue Code of 1954, since amended several times. It is important to see that you have the appropriate amendments for the year with which you are concerned.

Treaties

The United States has entered into a number of treaties with foreign countries which undertake to limit or prevent double taxation.[1] Probably the most important of these is the Reciprocal Tax Convention between the United States and Canada, ratified August 13, 1937, 50 Stat. 1399. See T.D. 4883, 1939–1 Cum. Bull. 147, and T.D. 4936, 1939–2 Cum.Bull. 101.[2] There is also a death tax convention with Canada. See T.D. 5455, 1945 Cum. Bull. 381.[3] Income and estate tax treaties are also in effect

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[1] See Froomkin and Wender, "Revenue Implications of United States Income Tax Treaties," 7 Nat.Tax J. 177 (1954).

[2] See King, "Income Tax Reciprocity with Canada," 17 Taxes 205 (1939).

[3] See Griswold, "The Canadian Death Tax Convention," 23 Taxes 402 (1945).

with Great Britain.[4] There are other treaties with Australia,[5] Austria,[6] Belgium,[7] Denmark,[8] Finland, France,[9] Germany,[10] Greece, Honduras, Ireland, Italy,[11] Japan,[10] the Netherlands,[8] New Zealand, Norway, Pakistan, Sweden, Switzerland, and the Union of South Africa.

Whenever a problem is encountered which involves a person from the United States deriving income (or having a taxable estate) in one of these countries, or a person from one of these countries having income (or a taxable estate) in the United States, or transactions between the United States and one of these countries, the provisions of the relevant treaty should be examined.[12]

2. Legislative Materials

Since the chief problems in federal taxation relate to the application and construction of statutes, it is important to be familiar with the materials which may shed light on these questions. These include:

(1) *Committee Reports.* Revenue Acts, like other statutes, are prepared for the consideration of Congress by Committees. These Committees present printed reports where many of the provisions of the Bill are considered in some detail. There is often a Report of a Subcommittee of the Committee on Ways and Means of the House of Representatives, which prepares the first draft of the Bill. There is almost always a Report of the Ways and Means Committee of the House, and a Report by the

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4 See Reiff, "An Unfortunate Interpretation of the United States-United Kingdom Income Tax Convention," 11 Tax Exec. 374 (1959); Koch, The Double Taxation Conventions (1947); Ehrenzweig and Koch, Income Tax Treaties (1950); Alexander, "The Income Tax Convention with the United Kingdom," 2 Tax L.Rev. 295 (1947); Rado, "Estate Tax Convention between Great Britain and the United States," 2 Tax L.Rev. 479 (1947).

5 See Carroll, "Income Tax Convention with Australia," 32 Taxes 61 (1954).

6 See Weissbarth, "The New Income Tax Convention with Austria," 35 Taxes 680 (1959).

7 See Carroll, "Income Tax Conventions between Belgium and the United States," 31 Taxes 554 (1953).

8 See Carroll, "Tax Convention with the Netherlands and Denmark," 26 Taxes 1026 (1948); Braun, "The United States-Netherlands Tax Treaty to Prevent Double Taxation," 34 Taxes 143 (1956).

9 See Carroll, "Tax Convention with France," 26 Taxes 592 (1948).

10 See Carroll, "Tax Conventions with Germany and Japan," 32 Taxes 897 (1954).

11 Carroll, "Income and Estate Tax Conventions with Italy," 33 Taxes 684 (1955); Rado, "The Tax Conventions between the United States and Italy," 14 Tax L.Rev. 203 (1959).

12 See, generally, Kust, "United States Tax Concessions for American Private Enterprise Abroad," 12 Tax Executive 143 (1960); Smith, "The Functions of Tax Treaties," 12 Nat.Tax J. 317 (1959); King, "Fiscal Cooperation in Tax Treaties," 26 Taxes 889 (1948); King, "Modification of United States Tax Law By Treaty," 26 Taxes 1001 (1948); Levy and Freedman, "Recent Tax Developments Affecting Foreign Transactions," 26 Taxes 1125 (1948); Allan and Coggan, "Tax Planning for Foreign Trade," 3 Tax L.Rev. 23 (1947).

Finance Committee of the Senate. There is usually a Conference Report, giving the results of the Conference Committee which adjusts the differences between the Bill as originally passed by the House, and the amendments made by the Senate.

In addition to these Committee Reports on the actual Bills, there are occasionally other reports which have a bearing on tax problems. Among these are Reports which have been issued from time to time by the Joint Committee on Internal Revenue Taxation; see sections 8001–8023 of the Internal Revenue Code of 1954 for the organization and functions of this Committee.

The Committee Reports are very fugitive documents and there are few libraries where they may be conveniently and completely found. The portions of the reports relating to income taxes, through the Revenue Act of 1938, have been collected in Seidman, Legislative History of Federal Income Tax Laws, 1938–1861 (1938). The full texts of the reports have also been reprinted in Part 2 of the 1939–1 Cum.Bull., and in subsequent issues of the Cumulative Bulletin, as the several later Acts have been passed. The reports on the Revenue Act of 1948 have been collected and collated in Wolkin and Manoff, Revenue Act of 1948 (1948). See also Seidman, Legislative History of Excess Profits Tax Laws, 1946–1917 (1947).

(2) *Hearings.* A stenographic record is kept of the public hearings before the Congressional Committees and these Hearings are published. They occasionally yield material which is useful in considering tax questions. See Hunter, "Six Thousand and Sixteen Pages," 28 Bull.Nat.Tax Ass'n 204 (1943), a review of the Hearings on the 1942 Act.

Sometimes the Ways and Means Committee holds extensive Hearings at which various persons are invited to give papers. For a recent example, see Tax Revision Compendium—Compendium of Papers on Broadening the Tax Base, 3 vols., House Ways and Means Committee, 1959.

(3) *Statements on the Floor of Congress.* The debates in Congress, recorded in the Congressional Record, are sometimes of moment in the construction of tax statutes. See *Hassett v. Welch,* 303 U.S. 303 (1938), for an example. Statements made by the member in charge of the Bill have about the status of Committee Reports.

(4) *Bills.* The drafts of the Bills in their various forms are sometimes of great aid in tracing the legislative development of a provision in the tax statutes. This is particularly true of the so-called Conference Print of the Bill, in which the amendments made by the Senate are numbered, and these are the numbers which are used in the Conference Report in discussing the provisions of the Bill. The Conference Print, by showing the exact

text of the provision referred to in the Conference Report is a useful, and often necessary, key to the proper understanding of the Report.

See Blough, The Federal Taxing Process (1952); Curtis, "The Procedure of Enacting a Revenue Bill," 31 Neb.L.Rev. 552 (1952).

3. Decisions

The annual grist of decisions in tax cases is immense; they come from the Supreme Court, the Courts of Appeals, including the Court of Appeals for the District of Columbia, the Court of Claims, the District Courts throughout the country, and the Tax Court, formerly the Board of Tax Appeals.[1] Occasionally, but very rarely, a federal tax question is decided by a State court, as when it comes up in a receivership or probate proceeding. *Matter of Rosenberg,* 269 N.Y. 247, 199 N.E. 206 (1935), and *Henk v. Columbus Auto Supply, Inc.,* — Minn. —, 101 N.W.2d 415 (1960), are examples.

The decisions of the Supreme Court, the Courts of Appeals, and the District Courts are published in the United States Reports, the Federal Reporter and in the Federal Supplement, respectively. The tax decisions of the Court of Claims are to be found in the Federal Supplement and also in the separate series of Court of Claims reports. The reported decisions of the Board of Tax Appeals and of the Tax Court are published in the B.T.A. and T.C. reports. The full text of the court decisions is most promptly available in the various tax services.[2] The reports appearing in the tax services are later gathered together and bound in two convenient sets, the American Federal Tax Reports (A.F. T.R.), and United States Tax Cases (U.S.T.C.). Many District Court cases and a few others are not officially reported; these opinions can be found only in the tax services, and later in the A.F.T.R. or U.S.T.C. Many of the opinions of the Tax Court (as formerly of the Board) are designated as Memoranda, and are not officially published. They may be found in full text in separate Tax Court services.

The best and most complete citation source in tax matters is the Prentice-Hall Federal Tax Citator Service. There is also a citator section, less complete, in the C.C.H. Federal Tax Service.

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1 The name of this tribunal was changed by sec. 504 of the Revenue Act of 1942, but, by the terms of the Act, this did not in any way change the "jurisdiction, powers and duties" of the agency or of its members.

2 See "How to Use the Federal Tax Services," 19 Conn.B.J. 129 (1945).

4. Treasury Regulations

The most important publications of the Treasury in the tax field are the formal Regulations. These are issued pursuant to the statutory authority now found in Sec. 7805(a) of the Internal Revenue Code of 1954, which provides that "the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement" of the internal revenue laws. The regulations are quite extensive in scope and detail. There is a separate publication for each tax or group of taxes imposed by Congress. They are usually designated by a number, and are revised from time to time. In 1954, the current income tax regulation was known as Regulations 118. It was issued under the old Internal Revenue Code (of 1939). The regulations under the Internal Revenue Code of 1954 are now nearly complete. They are known as the Income Tax Regulations, the Estate Tax Regulations, and the Gift Tax Regulations.

References have been made to many of the new Regulations at appropriate places in this book. No effort has been made to make comprehensive citations of the new Regulations.

One of the important and difficult matters in tax law is to get the "feel" of Regulations, to know what force and effect they have, when they will be followed, and when disregarded. Sometimes a regulation is effective in making taxable a transaction which might not otherwise appear to come within the statute. See *United States v. Kirby Lumber Co.,* 284 U.S. 1 (1931), *infra,* p. 208. At other times a regulation is said to go beyond the law and will not be enforced by the court. See *Commissioner v. Acker,* 361 U.S. 87 (1959); *Burnet v. Chicago Portrait Co.,* 285 U.S. 1 (1932). The effectiveness of a regulation may depend upon the length of time it has been in force, reenactment of the statute on which it is based, and the consistency with which the regulation has been maintained. Particular difficulty may arise when a regulation is changed, especially as to the retroactive application of the change.[3] Note the power of the Commissioner in this respect under Sec. 7805(b) of the Internal Revenue Code of 1954.[4]

An adequate conception of the problem of Regulations can only be acquired through familiarity with a considerable volume of

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3 For discussions, see Paul, "Use and Abuse of Tax Regulations in Statutory Construction," 49 Yale L.J. 660 (1940); Alvord, "Treasury Regulations and the Wilshire Oil Case," 40 Col.L.Rev. 252 (1940); Surrey, "Scope and Effect of Treasury Regulations Under the Income, Estate, and Gift Taxes," 88 U. of Pa.L.Rev. 556 (1940); Griswold, "A Summary of the Regulations Problem," 54 Harv.L.Rev. 398 (1941).

4 See "The Scope of the Treasury's Power to Issue Non-Retroactive Regulations," 39 Calif.L.Rev. 292 (1950).

tax cases. It is the tendency of students to fail to appreciate the importance of Regulations, and the complexity of the problems which they raise.

5. Treasury Rulings

In addition to the Regulations, which are ordinarily published separately, the Treasury publishes a considerable volume of Rulings. These appear in the Internal Revenue Bulletin, now published on a weekly basis. The material in the weekly issues is gathered together semi-annually into a publication known as the Cumulative Bulletin. The Rulings are also found in the Tax Services.

The Rulings of highest dignity are called Treasury Decisions, or T.D.'s.[5] These are usually amendments to the Regulations and have the status of Regulations. There are numerous other types of Rulings which have in the past been given varying names, such as General Counsel's Memoranda, and Mimeographs. Beginning in 1953, however, each substantive ruling or announcement published in the Internal Revenue Bulletin is designated as a "Rev. Rul.".[6] There are also Revenue Procedures, known as Rev.Proc., and Treasury Information Releases, known as T.I.R.

The importance of these Rulings in establishing practice, and the importance of practice in the construction of tax statutes are difficult to present in a casebook, but are matters for the careful consideration of the prospective tax practitioner.

E. A BRIEF GLIMPSE AT THE FIRST CENTURY AND A QUARTER

For an excellent discussion of the development of American taxation from 1789 to 1913, see Paul, Taxation in the United States cc. I, II, III (1954).

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[5] There is a separate series of T.D.'s for customs matters. See J. W. Hampton, Jr. & Co. v. United States, and Board of Trustees v. United States, supra, pp. 7, 12. There might be considerable possibility of confusion in this, but the cross-currents are almost non-existent. Apart from the two customs cases referred to, all references in this book are to internal revenue Treasury Decisions.

[6] The designation "I.R.Mim." is still used for internal communications where "the need exists." See Rev.Rul. 2, 1953-1 Cum.Bull. 484.

HYLTON v. UNITED STATES

Supreme Court of the United States, 1796, 3 Dallas 171.

The cause was argued by [Charles] Lee, the attorney-general of the United States and [Alexander] Hamilton,[1] the late secretary of the treasury, in support of the tax; and by [Alexander] Campbell, the attorney of the Virginia district, and [Jared] Ingersoll, the attorney-general of Pennsylvania, in opposition to it.[2]

CHASE, J. By the case stated, only one question is submitted to the opinion of this court—whether the law of congress of the 5th of June 1794, entitled, "An act to lay duties upon carriages for the conveyance of persons," is unconstitutional and void?

The principles laid down, to prove the above law void, are these: that a tax on carriages is a direct tax, and, therefore, by the constitution, must be laid according to the census, directed by the constitution to be taken, to ascertain the number of representatives from each state. And that the tax in question on carriages is not laid by that rule of apportionment, but by the rule of uniformity, prescribed by the constitution in the case of duties, imposts and excises; and a tax on carriages is not within either of those descriptions.

By the 2d section of the 1st article of the constitution, it is provided, that direct taxes shall be apportioned among the several states, according to their numbers, to be determined by the rule prescribed.

By the 9th section of the same article, it is further provided, that no capitation, or other direct tax, shall be laid, unless in proportion to the census or enumeration before directed.

By the 8th section of the same article, it was declared, that Congress shall have power to lay and collect taxes, duties, imposts and excises; but all duties, imposts and excises shall be uniform throughout the United States.

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1 A fragment of Hamilton's brief in this case has been preserved, and may be found in 7 Hamilton's Works 378–383 (Lodge's 2d ed., 1904). The following is one excerpt:

"The following are presumed to be the only direct taxes.

"Capitation or poll taxes.

"Taxes on lands and buildings.

"General assessments, whether on the whole property of individuals, or on their whole real or personal estate; all else must of necessity be considered as indirect taxes."

2 Interesting details about the setting of this case are given in 1 Warren, Supreme Court in United States History 146–149 (1932). It appears that Campbell and Ingersoll were paid $233.33 each, and Hamilton $500, for their services. Counsel on both sides were paid by the United States, as the issue was a feigned one, raised for the purpose of having the Court pass on the constitutional question.

As it was incumbent on the plaintiff's counsel in error, so they took great pains to prove that the tax on carriages was a direct tax; but they did not satisfy my mind. I think, at least, it may be doubted; and if I only doubted, I should affirm the judgment of the circuit court. The deliberate decision of the national legislature (who did not consider a tax on carriages a direct tax, but thought it was within the description of a duty), would determine me, if the case was doubtful, to receive the construction of the legislature; but I am inclined to think, that a tax on carriages is not a direct tax, within the letter or meaning of the constitution.

The great object of the constitution was, to give congress a power to lay taxes adequate to the exigencies of government; but they were to observe two rules in imposing them, namely, the rule of uniformity, when they laid duties, imposts or excises; and the rule of apportionment, according to the *census* when they laid any direct tax.

If there are any other species of taxes that are not direct, and not included within the words duties, imposts or excises, they may be laid by the rule of uniformity or not; as congress shall think proper and reasonable. If the framers of the constitution did not contemplate other taxes than direct taxes, and duties, imposts and excises, there is great inaccuracy in their language. If these four species of taxes were all that were meditated, the general power to lay taxes was unnecessary. If it was intended, that congress should have authority to lay only one of the four above enumerated, to wit, direct taxes by the rule of apportionment, and the other three by the rule of uniformity, the expressions would have run thus: "Congress shall have power to lay and collect direct taxes, and duties, imposts and excises; the first shall be laid according to the *census;* and the last three shall be uniform throughout the United States." The power, in the 8th section of the 1st article, to lay and collect taxes, included a power to lay direct taxes (whether capitation or any other), and also duties, imposts and excises; and every other species or kind of tax whatsoever, and called by any other name. Duties, imposts and excises were enumerated, after the general term taxes, only for the purpose of declaring, that they were to be laid by the rule of uniformity. I consider the constitution to stand in this manner. A general power is given to congress, to lay and collect taxes, of every kind or nature, without any restraint, except only on exports; but two rules are prescribed for their government, namely, uniformity and apportionment: Three kinds of taxes, to wit, duties, imposts and excises by the first rule, and capitation or other direct taxes, by the second rule.

I believe some taxes may be both direct and indirect, at the same time. If so, would congress be prohibited from laying such

a tax, because it is partly a direct tax? The constitution evidently contemplated no taxes as direct taxes, but only such as congress could lay in proportion to the *census.* The rule of apportionment is only to be adopted in such cases, where it can reasonably apply; and the subject taxed, must ever determine the application of the rule. If it is proposed to tax any specific article by the rule of apportionment, and it would evidently create great inequality and injustice, it is unreasonable to say, that the constitution intended such tax should be laid by that rule.

It appears to me, that a tax on carriages cannot be laid by the rule of apportionment, without very great inequality and injustice. For example: suppose, two states, equal in census, to pay $80,000 each, by a tax on carriages of eight dollars on every carriage; and in one state, there are 100 carriages, and in the other 1000. The owners of carriages in one state, would pay ten times the tax of owners in the other. A. in one state, would pay for his carriage eight dollars, but B. in the other state, would pay for his carriage, eighty dollars.

It was argued, that a tax on carriages was a direct tax, and might be laid according to the rule of apportionment, and (as I understood) in this manner: Congress, after determining on the gross sum to be raised, was to apportion it, according to the *census,* and then lay it in one state on carriages, in another on horses, in a third on tobacco, in a fourth on rice; and so on. I admit, that this mode might be adopted, to raise a certain sum in each state, according to the *census,* but it would not be a tax on carriages, but on a number of specific articles; and it seems to me, that it would be liable to the same objection of abuse and oppression, as a selection of any one article in all the states.

I think, an annual tax on carriages for the conveyance of persons, may be considered as within the power granted to congress to lay duties. The term *duty,* is the most comprehensive, next to the general term *tax;* and practically, in Great Britain (whence we take our general ideas of taxes, duties, imposts, excises, customs, &c.), embraces taxes on stamps, tolls for passage, &c., and is not confined to taxes on importation only. It seems to me, that a tax on expense is an indirect tax; and I think, an annual tax on a carriage for the conveyance of persons, is of that kind; because a carriage is a consumable commodity; and such annual tax on it, is on the expense of the owner.

I am inclined to think, but of this I do not give a judicial opinion, that the direct taxes contemplated by the constitution, are only two, to wit, a capitation or poll tax, simply, without regard to property, profession or any other circumstance; and

a tax on land. I doubt, whether a tax by a general assessment of personal property, within the United States, is included within the term direct tax.

As I do not think the tax on carriages is a direct tax, it is unnecessary, at this time, for me to determine, whether this court, constitutionally possesses the power to declare an act of congress void, on the ground of its being made contrary to, and in violation of, the constitution; but if the court have such power, I am free to declare, that I will never exercise it, but in a very clear case. I am for affirming the judgment of the circuit court.

The concurring opinions of JUSTICES PATERSON, IREDELL, and WILSON are omitted.[3]

Note

In *Veazie Bank v. Fenno,* 8 Wall. 533 (U.S. 1869), a federal tax on the issuance of state bank notes was upheld. The Court found that this was an "indirect" tax, and that it was not invalid because one of its principle purposes was the elimination of state bank notes, thus paving the way for a federal currency.

THE COLLECTOR v. DAY

Supreme Court of the United States, 1870. 11 Wallace 113.

MR. JUSTICE NELSON delivered the opinion of the Court.

The case presents the question whether or not it is competent for Congress, under the Constitution of the United States, to impose a tax upon the salary of a judicial officer of a State?

In *Dobbins v. The Commissioners of Erie County,* 16 Peters, 435, it was decided that it was not competent for the legislature of a State to levy a tax upon the salary or emoluments of an officer of the United States. The decision was placed mainly upon the ground that the officer was a means or instrumentality employed for carrying into effect some of the legitimate powers of the government, which could not be interfered with by taxation or otherwise by the States, and that the salary or compensation for the service of the officer was inseparably connected with the office; that if the officer, as such, was exempt, the salary assigned for his support or maintenance while holding the office was also, for like reasons, equally exempt.

The cases of *McCulloch v. Maryland,* 4 Wheaton, 316, and *Weston v. Charleston,* 2 Peters, 449, were referred to as settling the principle that governed the case, namely, "that the State govern-

[3] In 1861, Congress did levy a direct tax. It was cumbersome and ineffective in operation. See Dunbar, "The Direct Tax of 1861," 3 Q.J.Econ. 436 (1889).

ments cannot lay a tax upon the constitutional means employed by the government of the Union to execute its constitutional powers."

The soundness of this principle is happily illustrated by the Chief Justice in *McCulloch v. Maryland.* "If the States," he observes, "may tax one instrument employed by the government in the execution of its powers, they may tax any and every other instrument. They may tax the mail; they may tax the mint; they may tax patent-rights; they may tax judicial process; they may tax all the means employed by the government to an excess which would defeat all the ends of government." "This," he observes, "was not intended by the American people. They did not design to make their government dependent on the States." Again, "That the power of taxing it (the bank) by the States may be exercised so far as to destroy it, is too obvious to be denied." And, in *Weston v. The City of Charleston,* he observes: "If the right to impose the tax exists, it is a right which, in its nature, acknowledges no limits. It may be carried to any extent within the jurisdiction of the State or corporation which imposes it which the will of each State and corporation may prescribe."

It is conceded in the case of *McCulloch v. Maryland,* that the power of taxation by the States was not abridged by the grant of a similar power to the government of the Union; that it was retained by the States, and that the power is to be concurrently exercised by the two governments; and also that there is no express constitutional prohibition upon the States against taxing the means or instrumentalities of the general government. But, it was held, and, we agree properly held, to be prohibited by necessary implication; otherwise, the States might impose taxation to an extent that would impair, if not wholly defeat, the operations of the Federal authorities when acting in their appropriate sphere.

These views, we think, abundantly establish the soundness of the decision of the case of *Dobbins v. The Commissioners of Erie,* which determined that the States were prohibited, upon a proper construction of the Constitution, from taxing the salary or emoluments of an officer of the government of the United States. And we shall now proceed to show that, upon the same construction of that instrument, and for like reasons, that government is prohibited from taxing the salary of the judicial officer of a State.

It is a familiar rule of construction of the Constitution of the Union, that the sovereign powers vested in the State governments by their respective constitutions, remained unaltered and unimpaired, except so far as they were granted to the government of the United States. That the intention of the framers of the Constitution in this respect might not be misunderstood, this rule of

interpretation is expressly declared in the tenth article of the amendments, namely: "The powers not delegated to the United States are reserved to the States respectively, or, to the people." The government of the United States, therefore, can claim no powers which are not granted to it by the Constitution, and the powers actually granted must be such as are expressly given, or given by necessary implication.

The general government, and the States, although both exist within the same territorial limits, are separate and distinct sovereignties, acting separately and independently of each other, within their respective spheres. The former in its appropriate sphere is supreme; but the States within the limits of their powers not granted, or, in the language of the tenth amendment, "reserved," are as independent of the general government as that government within its sphere is independent of the States. . . .

We do not say the mere circumstances of the establishment of the judicial department, and the appointment of officers to administer the laws, being among the reserved powers of the State, disables the general government from levying the tax, as that depends upon the express power "to lay and collect taxes," but it shows that it is an original inherent power never parted with, and, in respect to which, the supremacy of that government does not exist, and is of no importance in determining the question; and further, that being an original and reserved power, and the judicial officers appointed under it being a means or instrumentality employed to carry it into effect, the right and necessity of its unimpaired exercise, and the exemption of the offices from taxation by the general government stand upon as solid a ground, and are maintained by principles and reasons as cogent as those which led to the exemption to the federal officer in *Dobbins v. The Commissioners of Erie* from taxation by the State; for, in this respect, that is, in respect to the reserved powers, the State is as sovereign and independent as the general government. And if the means and instrumentalities employed by that government to carry into operation the powers granted to it are, necessarily, and, for the sake of self-preservation, exempt from taxation by the States, why are not those of the States depending upon their reserved powers, for like reasons, equally exempt from Federal taxation? Their unimpaired existence in the one case is as essential as in the other. It is admitted that there is no express provision in the Constitution that prohibits the general government from taxing the means and instrumentalities of the States, nor is there any prohibiting the States from taxing the means and instrumentalities of that government. In both cases the exemption rests upon necessary implication, and is upheld by the great law of self preservation; as any government, whose means employed in conducting its operation, if subject to the control of

another and distinct government, can exist only at the mercy of that government. Of what avail are these means if another power may tax them at discretion?

But we are referred to the *Veazie Bank v. Fenno,* 8 Wallace, 533, in support of this power of taxation. That case furnishes a strong illustration of the position taken by the Chief Justice in *McCulloch v. Maryland,* namely, "That the power to tax involves the power to destroy."

The power involved was one which had been exercised by the States since the foundation of the government, and had been, after the lapse of three-quarters of a century, annihilated from excessive taxation by the general government, just as the judicial office in the present case might be, if subject, at all, to taxation by that government. But, notwithstanding the sanction of this taxation by a majority of the court, it is conceded, in the opinion, that "the reserved rights of the States such as the right to pass laws; to give effect to laws through executive action; to administer justice through the courts, and to employ all necessary agencies for legitimate purposes of State government, are not proper subjects of the taxing power of Congress." This concession covers the case before us, and adds the authority of this court in support of the doctrine which we have endeavored to maintain.

Judgment affirmed.

MR. JUSTICE BRADLEY, dissenting.

I dissent from the opinion of the court in this case, because, it seems to me that the general government has the same power of taxing the income of officers of the State governments as it has of taxing that of its own officers. It is the common government of all alike; and every citizen is presumed to trust his own government in the matter of taxation. No man ceases to be a citizen of the United States by being an officer under the State government. I cannot accede to the doctrine that the general government is to be regarded as in any sense foreign or antagonistic to the State governments, their officers, or people; nor can I agree that a presumption can be admitted that the general government will act in a manner hostile to the existence or functions of the State governments, which are constituent parts of the system or body politic forming the basis on which the general government is founded. The taxation by the State governments of the instruments employed by the general government in the exercise of its powers, is a very different thing. Such taxation involves the interference with the powers of a government in which other States and their citizens are equally interested with the State which imposes the taxation. In my judgment, the limitation of the power of taxation in the general government, which the present decision establishes, will be found

very difficult of control. Where are we to stop in enumerating the functions of the State governments which will be interfered with by Federal taxation? If a State incorporates a railroad to carry out its purposes of internal improvement, or a bank to aid its financial arrangements, reserving, perhaps, a percentage on the stock or profits, for the supply of its own treasury, will the bonds or stock of such an institution be free from Federal taxation? How can we now tell what the effect of this decision will be? I cannot but regard it as founded on a fallacy, and that it will lead to mischievous consequences. I am as much opposed as any one can be to any interference by the general government with the just powers of the State governments. But no concession of any of the just powers of the general government can easily be recalled. I, therefore, consider it my duty to at least record my dissent when such concession appears to be made. An extended discussion of the subject would answer no useful purpose.

Notes

(A) The individuals involved in *McCulloch v. Maryland* and in *Collector v. Day* both had checkered careers following their contribution to the constitutional law of intergovernmental immunities. McCulloch became involved in a defalcation in connection with the Bank of the United States, and was discharged. See *State v. Buchanan et al.*, 5 H. & J. 317–368 (Md.1821), McCulloch being one of the "al." See also *Etting v. United States Bank,* 11 Wheaton 59 (1826), involving a civil action arising out of the same affair. The episode is discussed in Swisher, Roger B. Taney 89–90 (1936); Catterall, The Second Bank of the United States 78–79 (1903).

In 1881, petitions bearing about one thousand signatures were filed against Judge Day. There were numerous charges, including drunkenness, and acting in cases in which he was interested in one way or another. There were seventeen hearings in 1881, and twenty-one hearings in 1882. Report of the Joint Special Committee of the Legislature of Massachusetts on the Removal of Joseph M. Day (1881); *ibid.* (1882). Finally, both houses of the Massachusetts Legislature adopted, by large majorities, an address for his removal, and he was removed by Governor John D. Long. See Boston Evening Transcript, April 29, 1941.

(B) The Supreme Court applied the reasoning of *Collector v. Day* in *Pollock v. Farmers Loan & Trust Co., infra,* p. 33, in a portion of its opinion holding that a federal income tax on the interest from municipal bonds was invalid. Although the rule of intergovernmental immunities remained strong for the next generation, a succession of cases developed in which the doctrine of immunity was limited. Thus the imposition of a succession tax on a bequest to a municipality was upheld in *Snyder v. Bettman,* 190 U.S. 249 (1903). And in *South Carolina v. United States,* 199 U.S. 437 (1905), the federal liquor excise tax was sustained as applied to a state owned and operated liquor store. See also *Greiner v. Lewellyn,* 258 U.S. 384 (1922) (municipal

bonds subject to federal estate tax); *New York v. United States,* 326 U.S. 572 (1946) (state subject to tax imposed on sale of mineral waters); and *Wilmette Park District v. Campbell,* 338 U.S. 411 (1949) (federal admissions tax applied to municipal bathing beach). See also *Helvering v. Gerhardt, infra,* p. 120.

Collector v. Day was formally overruled in *Graves v. New York ex rel. O'Keefe,* 306 U.S. 466, 486 (1939).

Most of the tax controversies in the latter part of the nineteenth century continued to turn on the question whether the tax was "direct" or not. In *Scholey v. Rew,* 23 Wall. 331 (U.S. 1874), a federal "succession tax," imposed on the "devolution of title to any real estate" was sustained. The tax was held to lie on the "transfer" of title, and thus to be "indirect."

SPRINGER v. UNITED STATES

Supreme Court of the United States, 1880. 102 U.S. 586.

MR. JUSTICE SWAYNE delivered the opinion of the Court.

The central and controlling question in this case is whether the tax which was levied on the income, gains, and profits of the plaintiff in error [by the Civil War Income Tax Act of June 30, 1864], as set forth in the record, and by pretended virtue of the acts of Congress and parts of acts therein mentioned, is a direct tax. . . .

Was the tax here in question a *direct* tax? If it was, not having been laid according to the requirements of the Constitution, it must be admitted that the laws imposing it, and the proceedings taken under them by the assessor and collector for its imposition and collection, were all void.

Many of the provisions of the Articles of Confederation of 1777 were embodied in the existing organic law. They provided for a common treasury and the mode of supplying it with funds. The latter was by requisitions upon the several States. The delays and difficulties in procuring the compliance of the States, it is known, was one of the causes that led to the adoption of the present Constitution. This clause of the articles throws no light on the question we are called upon to consider. Nor does the journal of the proceedings of the constitutional convention of 1787 contain anything of much value relating to the subject.

It appears that on the 11th of July, in that year, there was a debate of some warmth involving the topic of slavery. On the day following, Gouverneur Morris, of New York, submitted a proposition "that taxation shall be in proportion to representation." It is further recorded in this day's proceedings, that Mr. Morris having so varied his motion by inserting the word "direct,"

it passed *nem. con.*, as follows: "Provided always that direct taxes ought to be proportioned to representation." 2 Madison Papers, by Gilpin, pp. 1079–1081.

On the 24th of the same month, Mr. Morris said that "he hoped the committee would strike out the whole clause. . . . He had only meant it as a bridge to assist us over a gulf; having passed the gulf, the bridge may be removed. He thought the principle laid down with so much strictness liable to strong objections." *Id.* 1197. The gulf was the share of representation claimed by the Southern States on account of their slave population. But the bridge remained. The builder could not remove it, much as he desired to do so. All parties seem thereafter to have avoided the subject. With one or two immaterial exceptions, not necessary to be noted, it does not appear that it was again adverted to in any way. It was silently incorporated into the draft of the Constitution as that instrument was finally adopted.

It does not appear that an attempt was made by any one to define the exact meaning of the language employed.

In the twenty-first number of the Federalist, Alexander Hamilton, speaking of taxes generally, said: "Those of the *direct* kind, which principally relate to land and buildings, may admit of a rule of *apportionment*. Either the value of the land, or the number of the people, may serve as a standard." The thirty-sixth number of that work, by the same author, is devoted to the subject of internal taxes. It is there said, "They may be subdivided into those of the *direct* and those of the *indirect* kind." In this connection land-taxes and poll-taxes are discussed. The former are commended and the latter are condemned. Nothing is said of any other direct tax. In neither case is there a definition given or attempt of the phrase "direct tax."

The very elaborate researches of the plaintiff in error have furnished us with nothing from the debates of the State conventions, by whom the Constitution was adopted, which gives us any aid. Hence we may safely assume that no such material exists in that direction, though it is known that Virginia proposed to Congress an amendment relating to the subject, and that Massachusetts, South Carolina, New York, and North Carolina expressed strong disapprobation of the power given to impose such burdens. 1 Tucker's Blackstone, pt. 1, app., 235. . . .

The Constitution went into operation on the 4th of March, 1789.

It is important to look into the legislation of Congress touching the subject since that time. . . . In all of them the aggregate amount required to be collected was apportioned among the several States. . . .

It will thus be seen that whenever the government has imposed a tax which it recognized as a *direct tax,* it has never been applied to any objects but real estate and slaves. The latter application may be accounted for upon two grounds: 1. In some of the States slaves were regarded as real estate (1 Hurd, Slavery, 239; *Veazie Bank v. Fenno,* 8 Wall. 533); and, 2, such an extension of the tax lessened the burden upon the real estate where slavery existed, while the result to the national treasury was the same, whether the slaves were omitted or included. The wishes of the South were, therefore, allowed to prevail. We are not aware that the question of the validity of such a tax was ever presented for adjudication. Slavery having passed away, it cannot hereafter arise. It does not appear that any tax like the one here in question was ever regarded or treated by Congress as a direct tax. This uniform practical construction of the Constitution touching so important a point, through so long a period, by the legislative and executive departments of the government, though not conclusive, is a consideration of great weight. . . .

The question, what is a direct tax, is one exclusively in American jurisprudence. The text-writers of the country are in entire accord upon the subject.

Mr. Justice Story says all taxes are usually divided into two classes,—those which are *direct* and those which are *indirect,*—and that "under the former denomination are included taxes on land or real property, and, under the latter, taxes on consumption." 1 Const., sec. 950.

Chancellor Kent, speaking of the case of *Hylton v. United States,* says: "The better opinion seemed to be that the direct taxes contemplated by the Constitution were only two; viz., a capitation or poll tax and a tax on land." 1 Com. 257. See also Cooley, Taxation, p. 5, note 2; Pomeroy, Const.Law, 157; Sharswood's Blackstone, 308, note; Rawle, Const. 30; Sergeant, Const. 305. We are not aware that any writer, since *Hylton v. United States* was decided, has expressed a view of the subject different from that of these authors.

Our conclusions are, that *direct taxes,* within the meaning of the Constitution, are only capitation taxes, as expressed in that instrument, and taxes on real estate; and that the tax of which the plaintiff in error complains is within the category of an excise or duty. Pomeroy, Const.Law, 177; *Pacific Insurance Co. v. Soule* [7 Wall. 433], and *Scholey v. Rew* [23 Wall. 331].

Against the considerations, in one scale, in favor of these propositions, what has been placed in the other, as a counterpoise? Our answer is, certainly nothing of such weight, in our judgment, as to require any special reply. . . .

Judgment affirmed.

POLLOCK v. FARMERS' LOAN & TRUST COMPANY[1]

Supreme Court of the United States, 1895. 157 U.S. 429.

This was a bill filed by Charles Pollock, a citizen of the State of Massachusetts, . . . against the Farmers' Loan and Trust Company, . . . and its directors, . . . [The bill asserted that the income tax provisions of the Act of August 15, 1894, were unconstitutional on many grounds, and sought to enjoin the defendant and its officers from complying with the statute.]

Mr. James C. Carter for the Continental Trust Co., the defendant in a related case: These suggestions are all the more weighty and important in those controversies which, like the present are calculated to arouse the interests, the feelings—almost the passions—of the people, form the subject of public discussion, array class against class, and become the turning points in our general elections. Upon such subjects every freeman believes that he has a right to form his own opinion, and to give effect to that opinion by his vote. Nothing could be more unwise and dangerous—nothing more foreign to the spirit of the Constitution—than an attempt to baffle and defeat a popular determination by a judgment in a lawsuit. When the opposing forces of sixty millions of people have become arrayed in hostile political ranks upon a question which all men feel is not a question of law, but of legislation, the only path of safety is to accept the voice of the majority as final. The American people can be trusted not to commit permanent injustice; nor has history yet recorded an instance in which governments have been destroyed by attempts of the many to lay undue burdens of taxation on the few. The teachings of history have all been in the other direction.

Mr. Joseph H. Choate, for Pollock: I believe there are private rights of property here to be protected; that we have a right to come to this court and ask for their protection, and that this court has a right, without asking leave of the Attorney General or of any counsel, to hear our plea. The act of Congress which we are impugning before you is communistic in its purposes and tendencies, and is defended here upon principles as communistic, socialistic—what shall I call them—populistic as ever have been addressed to any political assembly in the world. . . .

Did your Honors observe what the learned counsel claimed, namely, that $20,000 might have been made the minimum of

[1] The reports of this case contain extended statements of the arguments of counsel, covering over a hundred and twenty pages, and the opinions themselves occupy over two hundred pages. The excerpts given here do not purport to be representative of the arguments presented or of the opinions.

exemption of taxation of this law, and there would have been no help for it? If you approve this law, with this exemption of $4000, and this communistic march goes on and five years hence a statute comes to you with an exemption of $20,000 and a tax of 20 per cent upon all having incomes in excess of that amount, how can you meet it in view of the decision which my opponents ask you now to render? There is protection now or never. . . . You cannot hereafter exercise any check if you now say that Congress is untrammelled and uncontrollable. My friend says you cannot enforce any limit. He says no matter what Congress does, if in its views of so-called—what did he call it?—sociology, political economy, it establishes a limit of a minimum of $20,000 or a minimum of $100,000, this court will have nothing to say about it. I agree that it will have nothing to say about it if it now lets go its hold upon this law—upon a law passed for such a purpose, accomplishing such a result and by such means.

MR. CHIEF JUSTICE FULLER delivered the opinion of the Court:

. . . The contention of the complainant is:

First. That the law in question, in imposing a tax on the income or rents of real estate, imposes a tax upon the real estate itself; and in imposing a tax on the interest or other income of bonds or other personal property held for the purposes of income or ordinarily yielding income, imposes a tax upon the personal estate itself; that such a tax is a direct tax, and void because imposed without regard to the rule of apportionment; and that by reason thereof the whole law is invalidated.

Second. That the law is invalid, because imposing indirect taxes in violation of the constitutional requirement of uniformity; and therein also in violation of the implied limitation upon taxation that all tax laws must apply equally, impartially, and uniformly to all similarly situated. Under the second head it is contended that the rule of uniformity is violated in that the law taxes the income of certain corporations, companies, and associations, no matter how created or organized, at a higher rate than the incomes of individuals or partnerships derived from precisely similar property or business; in that it exempts from the operation of the act and from the burden of taxation, numerous corporations, companies, and associations having similar property and carrying on similar business to those expressly taxed; in that it denies to individuals deriving their income from shares in certain corporations, companies, and associations the benefit of the exemption of $4000 granted to other persons interested in similar property and business; in the exemption of $4000; in the exemption of building and loan associations, savings banks, mutual life, fire, marine, and accident insurance companies, existing solely

for the pecuniary profit of their members; these and other exemptions being alleged to be purely arbitrary and capricious, justified by no public purpose, and of such magnitude as to invalidate the entire enactment; and in other particulars.

Third. That the law is invalid so far as imposing a tax upon income received from State and municipal bonds. . . .

Nothing can be clearer than that what the Constitution intended to guard against was the exercise by the general government of the power of directly taxing persons and property within any State through a majority made up from the other States. It is true that the effect of requiring direct taxes to be apportioned among the States in proportion to their population is necessarily that the amount of taxes on the individual taxpayer in a State having the taxable subject-matter to a larger extent in proportion to its population than another State has, would be less than in such other State, but this inequality must be held to have been contemplated, and was manifestly designed to operate to restrain the exercise of the power of direct taxation to extraordinary emergencies, and to prevent an attack upon accumulated property by mere force of numbers.

It is not doubted that property owners ought to contribute in just measure to the expenses of the government. As to the States and their municipalities, this is reached largely through the imposition of direct taxes. As to the Federal government, it is attained in part through excises and indirect taxes upon luxuries and consumption generally, to which direct taxation may be added to the extent the rule of apportionment allows. And through one mode or the other, the entire wealth of the country, real and personal, may be made, as it should be, to contribute to the common defence and general welfare.

But the acceptance of the rule of apportionment was one of the compromises which made the adoption of the Constitution possible, and secured the creation of that dual form of government, so elastic and so strong, which has thus far survived in unabated vigor. If, by calling a tax indirect when it is essentially direct the rule of protection could be frittered away, one of the great landmarks defining the boundary between the Nation and the States of which it is composed, would have disappeared, and with it one of the bulwarks of private rights and private property.

We are of the opinion that the law in question, so far as it levies a tax on the rents or income of real estate, is in violation of the Constitution, and is invalid.

Another question is directly presented by the record as to the validity of the tax levied by the act upon the income derived from municipal bonds. The averment in the bill is that the defendant company owns two millions of the municipal bonds of the city of

New York, from which it derives an annual income of $60,000, and that the directors of the company intend to return and pay the taxes on the income so derived.

The Constitution contemplates the independent exercise by the Nation and the State, severally, of their constitutional powers.

As the States cannot tax the powers, the operations, or the property of the United States, nor the means which they employ to carry their powers into execution, so it has been held that the United States have no power under the Constitution to tax either the instrumentalities or the property of a State. . . .

The law under consideration provides "that nothing herein contained shall apply to States, counties or municipalities." It is contended that although the property or revenues of the States or their instrumentalities cannot be taxed, nevertheless the income derived from state, county, and municipal securities can be taxed. But we think the same want of power to tax the property or revenues of the States or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason, and that reason is given by Chief Justice Marshall in *Weston v. Charleston,* 2 Pet. 449, 468, where he said: "The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is burthen on the operations of government. It may be carried to an extent which shall arrest them entirely. . . . The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the Constitution." Applying this language to these municipal securities, it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution.

Upon each of the other questions argued at the bar, to wit 1, Whether the void provisions as to rents and income from real estate invalidated the whole act? 2, Whether as to the income from personal property as such, the act is unconstitutional as laying direct taxes? 3, Whether any part of the tax, if not considered as a direct tax, is invalid for want of uniformity on either of the grounds suggested?—the justices who heard the argument[2] are equally divided, and, therefore, no opinion is expressed.

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[2] The justices who heard the original argument were Chief Justice Fuller, and Associate Justices Field (then 80 years old and about to retire: see King, Melville Weston Fuller, 222–230 (1950); Hughes, The Supreme Court

The result is that the decree of the Circuit Court is reversed and the cause remanded with directions to enter a decree in favor of the complainant in respect only of the voluntary payment of the tax on the rents and income of the real estate of the defendant company, and of that which it holds in trust, and on the income from the municipal bonds owned or so held by it.

[MR. JUSTICE FIELD wrote a long concurring opinion in which he expressed his view "that the whole law of 1894 should be declared void and without any binding force." Only one paragraph from the conclusion of this opinion is given here]:

"Here I close my opinion. I could not say less in view of questions of such gravity that go down to the very foundation of the government. If the provisions of the Constitution can be set aside by an act of Congress, where is the course of usurpation to end? The present assault upon capital is but the beginning. It will be but the stepping-stone to others, larger and more sweeping, till our political contests will become a war of the poor against the rich; a war constantly growing in intensity and bitterness."

The dissenting opinions of MR. JUSTICE WHITE and MR. JUSTICE HARLAN are omitted.

On rehearing.—158 U.S. 601 (1895).

MR. CHIEF JUSTICE FULLER delivered the opinion of the Court:

. . . Our previous decision was confined to the consideration of the validity of the tax on the income from real estate, and on the income from municipal bonds. The question thus limited was whether such taxation was direct or not, in the meaning of the Constitution; and the court went no farther, as to the tax on the income from real estate, than to hold that it fell within the same class as the source whence the income was derived, that is, that a tax upon the realty and a tax upon the receipts therefrom were alike direct; while as to the income from municipal bonds, that could not be taxed because of want of power to tax the source, and no reference was made to the nature of the tax as being direct or indirect.

We are now permitted to broaden the field of inquiry, and to determine to which of the two great classes a tax upon a person's entire income, whether derived from rents, or products, or otherwise, of real estate, or from bonds, stocks, or other forms

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of the United States 75–76 (1928); Fairman, "The Retirement of Federal Judges," 51 Harv.L.Rev. 397, 427 (1938)), Harlan, Gray, Brewer, Brown, Shiras, and White. Mr. Justice Jackson did not take part in the first decision because of illness.

of personal property, belongs; and we are unable to conclude that the enforced subtraction from the yield of all the owner's real or personal property, in the manner prescribed, is so different from a tax upon the property itself, that it is not a direct, but an indirect tax, in the meaning of the Constitution. . . .

Elaborate argument is made as to the efficacy and merits of an income tax in general, as on the one hand, equal and just, and on the other, elastic and certain; not that it is not open to abuse by such deductions and exemptions as might make taxation under it so wanting in uniformity and equality as in substance to amount to deprivation of property without due process of law; not that it is not open to fraud and evasion and is inquisitorial in its methods; but because it is preëminently a tax upon the rich, and enables the burden of taxes on consumption and of duties on imports to be sensibly diminished. And it is said that the United States as "the representative of an indivisible nationality, as a political sovereign equal in authority to any other on the face of the globe, adequate to all emergencies, foreign or domestic, and having at its command for offence and defence and for all governmental purposes all the resources of the nation," would be "but a maimed and crippled creation after all," unless it possesses the power to lay a tax on the income of real and personal property throughout the United States without apportionment. . . .

We are not here concerned with the question whether an income tax be or be not desirable, nor whether such a tax would enable the government to diminish taxes on consumption and duties on imports, and to enter upon what may be believed to be a reform of its fiscal and commercial system. Questions of that character belong to the controversies of political parties, and cannot be settled by judicial decision. In these cases our province is to determine whether this income tax on the revenue from property does or does not belong to the class of direct taxes. If it does, it is, being unapportioned, in violation of the Constitution, and we must so declare. . . .

Being of opinion that so much of the sections of this law as lays a tax on income frome real and personal property is invalid, we are brought to the question of the effect of that conclusion upon these sections as a whole.

It is elementary that the same statute may be in part constitutional and in part unconstitutional, and if the parts are wholly independent of each other, that which is constitutional may stand while that which is unconstitutional will be rejected. . . . Being invalid as to the greater part, and falling, as the tax would, if any part were held valid, in a direction which could not have been contemplated except in connection with the taxation con-

sidered as an entirety, we are constrained to conclude that sections twenty-seven to thirty-seven, inclusive, of the act, which became a law without the signature of the President on August 28, 1894, are wholly inoperative and void.

Our conclusions may, therefore, be summed up as follows:

First. We adhere to the opinion already announced, that, taxes on real estate being indisputably direct taxes, taxes on the rents or income of real estate are equally direct taxes.

Second. We are of opinion that taxes on personal property, or on the income of personal property, are likewise direct taxes.

Third. The tax imposed by sections twenty-seven to thirty-seven, inclusive, of the act of 1894, so far as it falls on the income of real estate and of personal property, being a direct tax within the meaning of the Constitution, and, therefore, unconstitutional and void because not apportioned according to representation, all those sections, constituting one entire scheme of taxation, are necessarily invalid.

The decrees hereinbefore entered in this court will be vacated; the decrees below will be reversed, and the cases remanded, with instructions to grant the relief prayed.

Dissenting opinions by JUSTICES HARLAN, BROWN, JACKSON, and WHITE are omitted.

Notes

This decision gave rise to a great amount of controversy, both at the time, and subsequently. See Boutwell, "The Decision of the Supreme Court," 160 North American Review 589 (1895); Pennoyer, "The Income Tax Decision, and The Power of the Supreme Court to Nullify Acts of Congress," 29 Amer.L.Rev. 550 (1895); Seligman, The Income Tax, cc. IV–V (2d ed., 1914); Corwin, Court over Constitution (1938) c. IV, entitled "The Court Makes a Misstep—The Pollock Case." The latter reference contains an interesting discussion as to which of the justices changed his mind between the first and second hearing. The author concludes that it was probably Mr. Justice Gray, despite a number of assertions that Mr. Justice Shiras was the vacillating jurist. But see King, Melville Weston Fuller 207–221 (1950).

Is the *Pollock* case still "law" today? See *Brushaber v. Union Pacific R. Co., infra,* p. 44, *New York Trust Co. v. Eisner, infra,* p. 806, and *Bromley v. McCaughn,* cited *infra* p. 964. In *New York ex rel. Cohn v. Graves,* 300 U.S. 308, 315 (1937), the Court held that New York might impose a tax on the income derived by one of its residents as rent for New Jersey land, saying: "Nothing which was said or decided in *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429, calls for a different conclusion. There the question for decision was whether a federal tax on income derived from rents of land is a direct tax requiring apportionment under Art. I, Sec. 2, cl. 3 of the Constitution. In holding that

the tax was 'direct,' the Court did not rest its decision upon the ground that the tax was a tax on the land, or that it was subject to every limitation which the Constitution imposes on property taxes. It determined only that for purposes of apportionment there were similarities in the operation of the two kinds of tax which made it appropriate to classify both as direct, and within the constitutional command." See also *Hale v. State Board,* 302 U.S. 95, 107 (1937).

KNOWLTON v. MOORE

Supreme Court of the United States, 1900. 178 U.S. 41.

MR. JUSTICE WHITE delivered the opinion of the Court.

The Act of Congress of June 13, 1898, c. 448, which is usually spoken of as the War Revenue Act, (20 [30] Stat. 448), imposes various stamp duties and other taxes. Sections 29 and 30 of the statute, which are therein prefaced by the heading "Legacies and Distributive Shares of Personal Property," provide for the assessment and collection of the particular taxes which are described in the sections in question. To determine the issues which arise on this record it is necessary to decide whether the taxes imposed are void because repugnant to the Constitution of the United States, and if they be valid, to ascertain and define their true import. . . .

It is conceded on all sides that the levy and collection of some form of death duty is provided by the sections of the law in question. Bearing this in mind, the exact form of the tax and the method of its assessment need not be presently defined, since doing so appropriately belongs to the more specific interpretation of the statute to which we shall hereafter direct our attention. Taxes of this general character are universally deemed to relate, not to property *eo nomine,* but to its passage by will or by descent in cases of intestacy, as distinguished from taxes imposed on property, real or personal as such, because of its ownership and possession. In other words, the public contribution which death duties exact is predicated on the passing of property as the result of death, as distinct from a tax on property disassociated from its transmission or receipt by will, or as the result of intestacy. Such taxes so considered were known to the Roman law and the ancient law of the continent of Europe. Smith's Wealth of Nations, London ed. of 1811, vol. 3, p. 311. . . .

Thus, looking over the whole field, and considering death duties in the order in which we have reviewed them, that is, in the Roman and ancient law, in that of modern France, Germany and other continental countries, in England and those of her colonies where such laws have been enacted, in the legislation of the United States and the several States of the Union, the following appears: Although different modes of assessing such du-

ties prevail, and although they have different accidental names, such as probate duties, stamp duties, taxes on the transaction, or the act of passing of an estate or a succession, legacy taxes, estate taxes or privilege taxes, nevertheless tax laws of this nature in all countries rest in their essence upon the principle that death is the generating source from which the particular taxing power takes its being and that it is the power to transmit, or the transmission from the dead to the living, on which such taxes are more immediately rested.

Having ascertained the nature of death duties, the first question which arises is this: Can the Congress of the United States levy a tax of that character? The proposition that it cannot rests upon the assumption that, since the transmission of property by death is exclusively subject to the regulating authority of the several States, therefore the levy by Congress of a tax on inheritances or legacies, in any form, is beyond the power of Congress, and is an interference by the National Government with a matter which falls alone within the reach of State legislation. It is to be remarked that this proposition denies to Congress the right to tax a subject-matter which was conceded to be within the scope of its power very early in the history of the government. The Act of 1797, which ordained legacy taxes, was adopted at a time when the founders of our government and framers of our Constitution were actively participating in public affairs, thus giving a practical construction to the Constitution which they had helped to establish. Even the then members of the Congress who had not been delegates to the convention, which framed the Constitution, must have had a keen appreciation of the influences which had shaped the Constitution and the restrictions which it embodied, since all questions which related to the Constitution and its adoption must have been, at that early date, vividly impressed on their minds. It would, under these conditions, be indeed surprising if a tax should have been levied without question upon objects deemed to be beyond the grasp of Congress because exclusively within State authority. It is, moreover, worthy of remark that similar taxes have at other periods and for a considerable time been enforced; and, although their constitutionality was assailed on other grounds held unsound by this court, the question of the want of authority of Congress to levy a tax on inheritances and legacies was never urged against the acts in question. . . .

But it is asserted that it was decided in the income tax cases that, in order to determine whether a tax be direct within the meaning of the Constitution, it must be ascertained whether the one upon whom by law the burden of paying it is first cast, can thereafter shift it to another person. If he cannot, the tax would then be direct in the constitutional sense, and, hence, however

obvious in other respects it might be a duty, impost or excise, it cannot be levied by the rule of uniformity and must be apportioned. From this assumed premise it is argued that death duties cannot be shifted from the one on whom they are first cast by law, and therefore they are direct taxes requiring apportionment.

The fallacy is in the premise. It is true that in the income tax cases the theory of certain economists by which direct and indirect taxes are classified with reference to the ability to shift the same was adverted to. But this disputable theory was not the basis of the conclusion of the court. The constitutional meaning of the word direct was the matter decided. Considering that the constitutional rule of apportionment had its origin in the purpose to prevent taxes on persons solely because of their general ownership of property from being levied by any other rule than that of apportionment, two things were decided by the court: First, that no sound distinction existed between a tax levied on a person solely because of his general ownership of real property, and the same tax imposed solely because of his general ownership of personal property. Secondly, that the tax on the income derived from such property, real or personal, was the legal equivalent of a direct tax on the property from which said income was derived, and hence must be apportioned. These conclusions, however, lend no support to the contention that it was decided that duties, imposts and excises which are not the essential equivalent of a tax on property generally, real or personal, solely because of its ownership, must be converted into direct taxes, because it is conceived that it would be demonstrated by a close analysis that they could not be shifted from the person upon whom they first fall. . . .

Concluding, then, that the tax under consideration is not direct within the meaning of the Constitution, but, on the contrary, is a duty or excise, we are brought to consider the question of uniformity.

The contention is that because the statute exempts legacies and distributive shares in personal property below ten thousand dollars, because it classifies the rate of tax according to the relationship or absence of relationship of the taker to the deceased, and provides for a rate progressing by the amount of the legacy or share, therefore the tax is repugnant to that portion of the first clause of section 8 of article 1 of the Constitution, which provides "the duties, imposts and excises shall be uniform throughout the United States." [1] . . .

Lastly, it is urged that the progressive rate feature of the statute is so repugnant to fundamental principles of equality and jus-

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[1] The Court concluded that "the words 'uniform throughout the United States' do not signify an intrinsic but simply a geographic uniformity."

tice that the law should be held to be void, even though it transgresses no express limitation in the Constitution. Without intimating any opinion as to the existence of a right of the courts to exercise the power which is thus invoked, it is apparent that the argument as to the enormity of the tax is without merit. It was disposed of in *Magoun v. Illinois Trust & Savings Bank,* 170 U.S. 283, 293.

The review which we have made exhibits the fact that taxes imposed with reference to the ability of the person upon whom the burden is placed to bear the same have been levied from the foundation of the government. So, also, some authoritative thinkers, and a number of economic writers, contend that a progressive tax is more just and equal than a proportional one. In the absence of constitutional limitation, the question whether it is or is not is legislative and not judicial. The grave consequences which it is asserted must arise in the future if the right to levy a progressive tax be recognized involves in its ultimate aspect the mere assertion that free and representative government is a failure, and that the grossest abuses of power are foreshadowed unless the courts usurp a purely legislative function. If a case should ever arise, where an arbitrary and confiscatory exaction is imposed bearing the guise of a progressive or any other form of tax, it will be time enough to consider whether the judicial power can afford a remedy by applying inherent and fundamental principles for the protection of the individual, even though there be no express authority in the Constitution to do so. That the law which we have construed affords no ground for the contention that the tax imposed is arbitrary and confiscatory, is obvious.

The judgment below must be reversed and the case be remanded, with instructions that further proceedings be had according to law and in conformity with this opinion, and it is so ordered.

MR. JUSTICE BREWER dissented from so much of the opinion as holds that a progressive rate of tax can be validly imposed. In other respects he concurred.

MR. JUSTICE PECKHAM took no part in the decision.

MR. JUSTICE HARLAN, with whom concurred MR. JUSTICE MCKENNA, dissented, with an opinion, which is omitted.

Note

By the Act of June 13, 1898, c. 448, 30 Stat. 448, Congress raised the stamp tax on the manufacture of tobacco from six cents to twelve cents a pound. Section 3 of the Act provided that any tobacco "held and intended for sale by any person" when the new act became effective, on which the six cent tax had been

paid, should be subject to a further tax of three cents a pound. In *Patton v. Brady,* 184 U.S. 608 (1902), the Court upheld this tax against the argument that it was direct and not apportioned. Compare the "floor stock" taxes imposed by section 16 of the Agricultural Adjustment Act, c. 25, 48 Stat. 31, 40, sec. 10 of the Liquor Taxing Act of 1934, c. 1, 48 Stat. 313, 315, secs. 212–214 of the Revenue Act of 1940, and secs. 602–605 of the Revenue Act of 1942.

BRUSHABER v. UNION PACIFIC RAILROAD CO.

Supreme Court of the United States, 1916. 240 U.S. 1.

MR. CHIEF JUSTICE WHITE delivered the opinion of the court.

As a stockholder of the Union Pacific Railroad Company the appellant filed his bill to enjoin the corporation from complying with the Income Tax provisions of the Tariff Act of October 3, 1913, (§ II, ch. 16, 38 Stat. 166). Because of constitutional questions duly arising the case is here on direct appeal from a decree sustaining a motion to dismiss because no ground for relief was stated.

. . . .

This is the text of the Amendment:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

It is clear on the face of this text that it does not purport to confer power to levy income taxes in a generic sense—an authority already possessed and never questioned—or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived. Indeed in the light of the history which we have given and of the decision in the *Pollock Case* and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the Amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock Case* was decided, that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment. From this in substance it indisputably arises, first, that all the contentions which we have previously noticed concerning the assumed

limitations to be implied from the language of the Amendment as to the nature and character of the income taxes which it authorizes find no support in the text and are in irreconcilable conflict with the very purpose which the Amendment was adopted to accomplish. Second, that the contention that the Amendment treats a tax on income as a direct tax although it is relieved from apportionment and is necessarily therefore not subject to the rule of uniformity as such rule only applies to taxes which are not direct, thus destroying the two great classifications which have been recognized and enforced from the beginning, is also wholly without foundation since the command of the Amendment that all income taxes shall not be subject to apportionment by a consideration of the sources from which the taxed income may be derived, forbids the application to such taxes of the rule applied in the *Pollock Case* by which alone such taxes were removed from the great class of excises, duties and imposts subject to the rule of uniformity and were placed under the other or direct class. This must be unless it can be said that although the Constitution as a result of the Amendment in express terms excludes the criterion of source of income, that criterion yet remains for the purpose of destroying the classifications of the Constitution by taking an excise out of the class to which it belongs and transferring it to a class in which it cannot be placed consistently with the requirements of the Constitution. . . .

We come then to ascertain the merits of the many contentions made in the light of the Constitution as it now stands, that is to say, including within its terms the provisions of the Sixteenth Amendment as correctly interpreted. We first dispose of two propositions assailing the validity of the statute on the one hand because of its repugnancy to the Constitution in other respects, and especially because its enactment was not authorized by the Sixteenth Amendment.

The statute was enacted October 3, 1913, and provided for a general yearly income tax from December to December of each year. Exceptionally, however, it fixed a first period embracing only the time from March 1, to December 31, 1913, and this limited retroactivity is assailed as repugnant to the due process clause of the Fifth Amendment and as inconsistent with the Sixteenth Amendment itself. But the date of the retroactivity did not extend beyond the time when the Amendment was operative, and there can be no dispute that there was power by virtue of the Amendment during that period to levy the tax, without apportionment, and so far as the limitations of the Constitution in other respects are concerned, the contention is not open, since in *Stockdale v. Insurance Companies,* 20 Wall. 323, 331, in sustaining a provision in a prior income tax law which was assailed because of its retroactive character, it was said:

> "The right of Congress to have imposed this tax by a new statute, although the measure of it was governed by the income of the past year, cannot be doubted; much less can it be doubted that it could impose such a tax on the income of the current year, though part of that year had elapsed when the statute was passed. The joint resolution of July 4th, 1864, imposed a tax of five per cent. upon all income of the previous year, although one tax on it had already been paid, and no one doubted the validity of the tax or attempted to resist it."

The statute provides that the tax should not apply to enumerated organizations or corporations, such as labor, agricultural or horticultural organizations, mutual savings banks, etc., and the argument is that as the Amendment authorized a tax on incomes "from whatever source derived," by implication it excluded the power to make these exemptions. But this is only a form of expressing the erroneous contention as to the meaning of the Amendment, which we have already disposed of. And so far as this alleged illegality is based on other provisions of the Constitution, the contention is also not open, since it was expressly considered and disposed of in *Flint v. Stone Tracy Co.,* 220 U.S. 108, 173.

Without expressly stating all the other contentions, we summarize them to a degree adequate to enable us to typify and dispose of all of them.

1. The statute levies one tax called a normal tax on all incomes of individuals up to $20,000 and from that amount up by gradations, a progressively increasing tax called an additional tax, is imposed. No tax, however, is levied upon incomes of unmarried individuals amounting to $3,000 or less nor upon incomes of married persons amounting to $4,000 or less. The progressive tax and the exempted amounts, it is said, are based on wealth alone and the tax is therefore repugnant to the due process clause of the Fifth Amendment.

2. The act provides for collecting the tax at the source, that is, makes it the duty of corporations, etc., to retain and pay the sum of the tax on interest due on bonds and mortgages, unless the owner to whom the interest is payable gives a notice that he claims an exemption. This duty cast upon corporations, because of the cost to which they are subjected, is asserted to be repugnant to due process of law as a taking of their property without compensation, and we recapitulate various contentions as to discrimination against corporations and against individuals predicated on provisions of the act dealing with the subject:

(a) Corporations indebted upon coupon and registered bonds are discriminated against, since corporations not so indebted are

relieved of any labor or expense involved in deducting and paying the taxes of individuals on the income derived from bonds.

(b) Of the class of corporations indebted as above stated, the law further discriminates against those which have assumed the payment of taxes on their bonds, since although some or all of their bondholders may be exempt from taxation, the corporations have no means of ascertaining such fact, and it would therefore result that taxes would often be paid by such corporations when no taxes were owing by the individuals to the Government.

(c) The law discriminates against owners of corporate bonds in favor of individuals none of whose income is derived from such property, since bondholders are, during the interval between the deducting and the paying of the tax on their bonds, deprived of the use of the money so withheld.

(d) Again corporate bondholders are discriminated against because the law does not release them from payment of taxes on their bonds even after the taxes have been deducted by the corporation, and therefore if after deduction the corporation should fail, the bondholders would be compelled to pay the tax a second time.

(e) Owners of bonds the taxes on which have been assumed by the corporation are discriminated against because the payment of the taxes by the corporation does not relieve the bondholders of their duty to include the income from such bonds in making a return of all income, the result being a double payment of the taxes, labor and expense in applying for a refund, and a deprivation of the use of the sum of the taxes during the interval which elapses before they are refunded.

3. The provision limiting the amount of interest paid which may be deducted from gross income of corporations for the purpose of fixing the taxable income to interest on indebtedness and paid-up capital stock, is also charged to be wanting in due process because discriminating between different classes of corporations and individuals.

4. It is urged that want of due process results from the provision allowing individuals to deduct from their gross income dividends paid them by corporations whose incomes are taxed and not giving such right of deduction to corporations.

5. Want of due process is also asserted to result from the fact that the act allows a deduction of $3,000 or $4,000 to those who pay the normal tax, that is, whose incomes are $20,000 or less, and does not allow the deduction to those whose incomes are greater than $20,000; that is, such persons are not allowed for the purpose of the additional or progressive tax a second right to deduct the $3,000 or $4,000 which they have already enjoyed. And a further violation of due process is based on the fact that

for the purpose of the additional tax no second right to deduct dividends received from corporations is permitted.

6. In various forms of statement, want of due process, it is moreover insisted, arises from the provisions of the act allowing a deduction for the purpose of ascertaining the taxable income of stated amounts on the ground that the provisions discriminate between married and single people and discriminate between husbands and wives who are living together and those who are not.

7. Discrimination and want of due process results, it is said, from the fact that the owners of houses in which they live are not compelled to estimate the rental value in making up their incomes, while those who are living in rented houses and pay rent are not allowed, in making up their taxable income, to deduct rent which they have paid, and that want of due process also results from the fact that although family expenses are not as a rule permitted to be deducted from gross, to arrive at taxable, income, farmers are permitted to omit from their income return, certain products of the farm which are susceptible of use by them for sustaining their families during the year.

So far as these numerous and minute, not to say in many respects hypercritical, contentions are based upon an assumed violation of the uniformity clause, their want of legal merit is at once apparent, since it is settled that that clause exacts only a geographical uniformity and there is not a semblance of ground in any of the propositions for assuming that a violation of such uniformity is complained of. *Knowlton v. Moore,* 178 U.S. 41; *Patton v. Brady,* 184 U.S. 608, 622; *Flint v. Stone Tracy Co.,* 220 U.S. 107, 158; *Billings v. United States,* 232 U.S. 608, 622.

So far as the due process clause of the Fifth Amendment is relied upon, it suffices to say that there is no basis for such reliance since it is equally well settled that such clause is not a limitation upon the taxing power conferred upon Congress by the Constitution; in other words, that the Constitution does not conflict with itself by conferring upon the one hand a taxing power and taking the same power away on the other by the limitations of the due process clause. *Treat v. White,* 181 U.S. 264; *Patton v. Brady,* 184 U.S. 608; *McCray v. United States,* 195 U.S. 27, 61; *Flint v. Stone Tracy Co., supra; Billings v. United States,* 232 U.S. 261, 282. . . . It is true that it is elaborately insisted that although there be no express constitutional provision prohibiting it, the progressive feature of the tax causes it to transcend the conception of all taxation and to be a mere arbitrary abuse of power which must be treated as wanting in due process. But the proposition disregards the fact that in the very early history of the Government a progressive tax was imposed by Congress and that such authority was exerted in some if not

all of the various income taxes enacted prior to 1894 to which we have previously adverted. . . .

We have not referred to a contention that because certain administrative powers to enforce the act were conferred by the statute upon the Secretary of the Treasury, therefore it was void as unwarrantedly delegating legislative authority, because we think to state the proposition is to answer it. *Field v. Clark,* 143 U.S. 649; *Buttfield v. Stranahan,* 192 U.S. 470, 496; *Oceanic Steam Navigation Co. v. Stranahan,* 214 U.S. 320.

Affirmed.

F. ARE THERE ANY LIMITS TO THE NATURE AND OBJECTIVES OF FEDERAL TAXES?

The federal taxpayer generally has no standing to challenge the validity of Congressional appropriations. His interest in the moneys of the Treasury is considered "minute and indeterminable," and the effects of the appropriation on future taxation "remote, fluctuating, and uncertain." *Frothingham v. Mellon,* 262 U.S. 447 (1923). However, an individual is not precluded from challenging the constitutionality of a tax imposed on him. Thus problems of federalism, of the proper balance of power between the Nation and the States, occasionally arise in tax cases. These are problems of general constitutional law which cannot be handled here. Similarly, the question of due process limitations appears in tax cases, as elsewhere. Both fields are now much more the province of the constitutional historian than they were some years ago.

In the internal revenue act of 1864 (amended in 1866) Congress imposed a special tax on sellers of lottery tickets and on retail liquor dealers. The Supreme Court upheld the tax, saying: ". . . the power of Congress to tax is a very extensive power. It is given in the Constitution, with only one exception and two qualifications. Congress cannot tax exports, and it must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity. Thus limited, and thus only, it reaches every subject, and may be exercised at discretion." *License Tax Cases,* 5 Wall. 462, 471 (U.S. 1866). Undoubtedly the discretion of Congress is very broad. In *Veazie Bank v. Fenno,* 8 Wall. 533 (U.S. 1869), the Court sustained a prohibitory tax on state bank notes; and after more than a century of practice, the Court, in *Hampton & Co. v. United States, supra,* p. 7, upheld a tax on imports although one of the objectives of the tax was the protection of domestic industries.

But federal taxes have not always found acceptance by the Court. Title XII of the Revenue Act of 1918 imposed a "Tax

on the Employment of Child Labor." This was a tax of ten per cent of the net profits of any employer who "during any portion of the taxable year" had employed child labor.[1] In the *Child Labor Tax Case,* 259 U.S. 20 (1922), this tax was held unconstitutional. The Court said (p. 38): "Grant the validity of this law, and all that Congress would need to do, hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the States have never parted with, and which are reserved to them by the Tenth Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a so-called tax upon departures from it. To give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states." For a discussion and analysis of this case, see Powell, "Child Labor, Congress, and the Constitution", 1 No.Car.L.Rev. 61 (1922). On the same day, the Court decided *Hill v. Wallace,* 259 U.S. 44 (1922), holding unconstitutional the taxing provisions of the Future Trading Act of 1921.[2]

The next, and (for the time being) last, great battle in this field was over the processing taxes imposed by the Agricultural Adjustment Act of May 12, 1933, c. 25, 48 Stat. 31. Section 9(a) of this statute imposed a tax "upon the first domestic processing" of certain commodities. The amount of the tax was to be fixed by the Secretary of Agriculture at a rate equal to the difference between "the current average farm price for the commodity" and the price which would "give the commodity the same purchasing

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1 This statute was enacted immediately after the Supreme Court in Hammer v. Dagenhart, 247 U.S. 251 (1918), had held unconstitutional a statute by which Congress had undertaken to prohibit the transportation in interstate commerce of goods made at a factory where child labor was employed. See Powell, "The Child Labor Law, the Tenth Amendment and the Commerce Clause," 3 Southern L.Q. 175 (1918).

The Fair Labor Standards Act of 1938, c. 676, sec. 12, 52 Stat. 1060, 1067, provides that "no producer, manufacturer, or dealer shall ship or deliver for shipment in commerce any goods produced in an establishment situated in the United States in or about which within thirty days prior to the removal of such goods therefrom any oppressive child labor [as defined in the Act] has been employed." In United States v. Darby, 312 U.S. 100 (1941), the Act was sustained without direct reference to the Child Labor provisions, and Hammer v. Dagenhart was formally overruled.

2 Section 91(3) of the British North America Act gives the Canadian Dominion Parliament authority in matters of taxation. Held, that this does not authorize the enactment of a statute imposing a tax on persons conducting the insurance business without a license under the Dominion Insurance Act, when power to regulate insurance is not given to the Dominion Government. Re Insurance Act and Special War Revenue Act, [1932] 1 D.L.R. 97. Viscount Dunedin, speaking for the Privy Council, said (p. 106): "Now as to the power of the Dominion parliament to impose taxation, there is no doubt. But if the tax as imposed is linked up with an object which is illegal, the tax for that purpose must fall." See also Re Reciprocal Insurance Legislation, [1924] 1 D.L.R. 789.

power, with respect to articles farmers buy, as such commodity had" in the pre-war period, 1909–1914. By section 12 of the Act, "the proceeds derived from all taxes imposed under this title" were appropriated for specific agricultural purposes, including rental and benefit payments to farmers. These benefit payments were to be made to farmers who entered into agreements to reduce production of the commodities.

In *United States v. Butler,* 297 U.S. 1 (1936), this tax was held unconstitutional. The majority of the Court, speaking through Mr. Justice Roberts, said (p. 74): "Congress has no power to enforce its commands on the farmer to the ends sought by the Agricultural Adjustment Act. It must follow that it may not indirectly accomplish those ends by taxing and spending to purchase compliance. The Constitution and the entire plan of our government negative any such use of the power to tax and to spend as the act undertakes to authorize." [3] Mr. Justice Stone filed an eloquent dissent in which Justices Brandeis and Cardozo concurred. The discussions of the case are very numerous. Among them the following may be mentioned: Hart, "Processing Taxes and Protective Tariffs," 49 Harv.L.Rev. 610 (1936); Powell, "Processing Tax and Social Security Act," 5 Brooklyn L.Rev. 125 (1936); Brown, "When Is a Tax not a Tax?" 11 Ind.L.J. 399 (1936).[4] The present status of the *Butler* case may be gathered

[3] This decision left a tremendous backwash. Over a billion dollars in processing taxes had been collected. The provisions which Congress established to govern the allowance (and prevention of allowance) of refunds of these taxes are referred to at p. 1026 (C), below.

The decision in United States v. Butler at no time had any appreciable effect on the federal Government's efforts to control or aid agriculture. The Agricultural Adjustment Act of 1938, c. 30, 52 Stat. 31, for example, provided for the making of parity payments to farmers and continued the provisions of the Soil Conservation Act of 1936, c. 104, 49 Stat. 1148, which provided for making payments to farmers who engaged in certain soil-conserving practices, such as not growing crops of which there was a domestic surplus. The net result is roughly that the "coercion" remains unchanged, but the cost is financed by other taxes and by borrowing—a rather Pyrrhic victory from the conservative point of view.

[4] Taxing statutes were also held unconstitutional in two other cases at about the same time as the Butler case. In Railroad Retirement Board v. Alton Railroad Co., 295 U.S. 330 (1935), the Court struck down the taxing provisions of the Railroad Retirement Act of 1934, c. 868, 48 Stat. 1283. See Powell, "Commerce, Pensions and Codes," 49 Harv.L.Rev. 1, 193 (1935). [This law was later reenacted with some changes (now found in sections 3201–3233 of the Internal Revenue Code of 1954), and was sustained in California v. Anglim, 129 F.2d 455 (C.C.A. 9th, 1942), certiorari denied, 317 U.S. 669 (1942). The present status of the Alton Railroad case in the eyes of the Court may be gathered from its refusal to review the Anglim case, and from United States v. Lowden, 308 U.S. 225, 239 (1939).] The other tax invalidated was that imposed by the Bituminous Coal Conservation Act of 1935, c. 824, 49 Stat. 991, commonly known as the Guffey Coal Act. This tax was subject to a credit of ninety per cent in favor of producers who submitted to the price-fixing and labor provisions of the Act. This was held to be "clearly not a tax but a penalty . . . to compel compliance with the regulatory provisions of the act." Carter v. Carter Coal Co., 298 U.S. 238, 288–289 (1936). The objec-

from an examination of the opinion in *Mulford v. Smith,* 307 U.S. 38 (1939), which sustained the validity of the Agricultural Adjustment Act of 1938. This provided a penalty of fifty per cent of the market price of tobacco which was marketed by a farmer in excess of his quota. This penalty was to be collected by the warehouseman and paid to the Secretary of Agriculture. The Court, speaking through Mr. Justice Roberts, who wrote the opinion in the *Butler* case, held that the penalty was not a tax, and that the regulation was valid.

A similar attitude was evidenced in *Sunshine Anthracite Coal Co. v. Adkins,* 310 U.S. 381 (1940). This sustained the tax imposed by section 3(b) of the Bituminous Coal Act of 1937, c. 125, 50 Stat. 72. This was a tax of 19½ per cent of the sale price at the mine on bituminous coal. By the following paragraph of the statute producers who were members of the code established by the Bituminous Coal Commission (later the Bituminous Coal Division of the Department of the Interior) were exempted from the tax. This code, among other matters, provided for minimum prices at which coal might be sold. In upholding the tax, the Court said:

"Clearly this tax is not designed merely for revenue purposes. In purpose and effect it is primarily a sanction to enforce the regulatory provisions of the Act. But that does not mean that the statute is invalid and the tax unenforceable. Congress may impose penalties in aid of the exercise of any of its enumerated powers. The power of taxation, granted to Congress by the Constitution, may be utilized as a sanction for the exercise of another power which is granted it. *Head Money Cases,* 112 U.S. 580, 596. And see *Sonzinsky v. United States,* 300 U.S. 506. It is so utilized here."

The general question was examined (without the benefit of a good deal of subsequent history) in Cushman, "Social and Economic Control Through Federal Taxation," 18 Minn.L.Rev. 759 (1934).[5] *Cf.* Shultz, "Regulatory Taxes," 17 Taxes 515, 517 (1939): "A 'pure tax,' one that produces revenue without in any way altering the economic order, is a figment of the fiscal theorists' imaginations." See also Gray, "Income Tax Deductions as a Means of Effectuating Governmental Policies," 2 Wash. & Lee L.Rev. 191 (1941).

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tives of this statute, too, have been largely achieved by the Bituminous Coal Act of 1937, referred to in the text below.

[5] See also a number of articles included in a symposium on "Regulation through Taxation" in 23 Corn.L.Q. 1–166 (1937); Buehler, "Regulatory Taxation," 17 Harv.Bus.Rev. 138 (1939); Cooper, "Some Economic Effects of Taxation," 17 Taxes 566 (1939); Kendrick, "The Incidence and Effects of Taxation," 27 Am.Econ.Rev. 725 (1937); Fagan, "Recent and Contemporary Theories of Progressive Taxation," 46 J.Pol.Econ. 457 (1938); Facing the Tax Problem (Twentieth Century Fund, 1937) 129–216.

Consider the following excerpts from messages of President Roosevelt:

". . . because of the very sound public policy of encouraging a wider distribution of wealth, . . ." Message to Congress, June 19, 1935, House Report No. 1681, 74th Congress, 1st Session, p. 2; Senate Report No. 1240, 74th Congress, 1st Session, p. 3.

". . . we in this country are getting more practical results in the way of bettering the social conditions of the nation out of our taxes than ever before in our history." Address at Arthurdale, West Virginia, May 27, 1938, 83 Cong.Rec., Part 7, pp. 7616, 7618; 8002, 8004.

See Todd, "Taxation and the Redistribution of Wealth," 22 Bull.Nat. Tax Assn. 269 (1937); Facing the Tax Problem (Twentieth Century Fund, 1937), c. 14.

Secretary of the Treasury George M. Humphrey, testifying before the Subcommittee on Legal and Monetary Affairs of the Government Operations Committee on July 18, 1955, said:

"The power to tax is the power to destroy, and revenue laws should be used only to raise revenue equitably, and not for other indirect purposes. It is dangerous to use the tax laws for social purposes, to favor one citizen or group of citizens over others, to exercise economic controls, or to indirectly subsidize any segment of our economy.

"If, in the wisdom of the Congress, such subsidies or assistance to special communities or for special purposes are desired, then appropriations should be made for the purpose which can be submitted to the Congress through regular channels where the amounts will be well known and where the Congress specifically can vote in favor of or in opposition to special treatment for any group. Under this program of tax reduction in special cases, our net revenues can be reduced and our deficits increased without formal action or appropriations by the Congress. This use of the tax laws, where the stimulants are applied by men, not by law, is appropriate only in an emergency or under special conditions under rigid restrictions when usual procedures are inadequate for our protection."

See Study of the Tax Amortization Program, Hearings before the Subcommittee on Legal and Monetary Affairs of the

Committee on Government Operations, House of Representatives, p. 75 (1955); also in Annual Report of the Secretary of the Treasury for the Fiscal Year Ended June 30, 1955, p. 233–234.

For a full consideration of these questions, see Paul, Taxation in the United States 643–655 (1954).

STEWARD MACHINE CO. v. DAVIS

Supreme Court of the United States, 1937. 301 U.S. 548.

MR. JUSTICE CARDOZO delivered the opinion of the Court.

The validity of the tax imposed by the Social Security Act on employers of eight or more is here to be determined.

Petitioner, an Alabama corporation, paid a tax in accordance with the statute, filed a claim for refund with the Commissioner of Internal Revenue, and sued to recover the payment ($46.14), asserting a conflict between the statute and the Constitution of the United States. Upon demurrer the District Court gave judgment for the defendant dismissing the complaint, and the Circuit Court of Appeals for the Fifth Circuit affirmed. 89 F.2d 207.

. . .

The Social Security Act (Act of August 14, 1935, c. 531, 49 Stat. 620) is divided into eleven separate titles, of which only titles IX and III are so related to this case as to stand in need of summary.

The caption of title IX is "Tax on Employers of Eight or More." Every employer (with stated exceptions) is to pay for each calendar year "an excise tax, with respect to having individuals in his employ," the tax to be measured by prescribed percentages of the total wages payable by the employer during the calendar year with respect to such employment. Section 901. One is not, however, an "employer" within the meaning of the act unless he employs eight persons or more. Section 907(a). There are also other limitations of minor importance. The term "employment" too has its special definition, excluding agricultural labor, domestic service in a private home, and some other smaller classes. Section 907(c). The tax begins with the year 1936, and is payable for the first time on January 31, 1937. During the calendar year 1936 the rate is to be 1 per cent., during 1937 2 per cent., and 3 per cent. thereafter. The proceeds, when collected, go into the Treasury of the United States like internal revenue collections generally. Section 905(a). They are not earmarked in any way. In certain circumstances, however, credits are allowable. Section 902. If the taxpayer has made contributions to an unemployment fund under a state law, he may credit such contributions against the federal tax, provided, how-

ever, that the total credit allowed to any taxpayer shall not exceed ninety per centum of the tax against which it is credited, and provided also that the state law shall have been certified to the Secretary of the Treasury by the Social Security Board as satisfying certain minimum criteria. Section 902. . . . Some of the conditions thus attached to the allowance of a credit are designed to give assurance that the state unemployment compensation law shall be one in substance as well as name. Others are designed to give assurance that the contributions shall be protected against loss after payment to the state. To this last end there are provisions that before a state law shall have the approval of the Board it must direct that the contributions to the state fund be paid over immediately to the Secretary of the Treasury to the credit of the "Unemployment Trust Fund." . . . For the moment it is enough to say that the fund is to be held by the Secretary of the Treasury, who is to invest in government securities any portion not required in his judgment to meet current withdrawals. He is authorized and directed to pay out of the fund to any competent state agency such sums as it may duly requisition from the amount standing to its credit. Section 904 (f). . . .

The assault on the statute proceeds on an extended front. Its assailants take the ground that the tax is not an excise; that it is not uniform throughout the United States as excises are required to be; that its exceptions are so many and arbitrary as to violate the Fifth Amendment; that its purpose was not revenue, but an unlawful invasion of the reserved powers of the states; and that the states in submitting to it have yielded to coercion and have abandoned governmental functions which they are not permitted to surrender.

The objections will be considered seriatim with such further explanation as may be necessary to make their meaning clear.

First. The tax, which is described in the statute as an excise, is laid with uniformity throughout the United States as a duty, an impost, or an excise upon the relation of employment.

1. We are told that the relation of employment is one so essential to the pursuit of happiness that it may not be burdened with a tax. Appeal is made to history. From the precedents of colonial days, we are supplied with illustrations of excises common in the colonies. They are said to have been bound up with the enjoyment of particular commodities. Appeal is also made to principle or the analysis of concepts. An excise, we are told, imports a tax upon a privilege; employment, it is said, is a right, not a privilege, from which it follows that employment is not subject to an excise. Neither the one appeal nor the other leads to the desired goal.

As to the argument from history: Doubtless there were many excises in colonial days and later that were associated, more or less intimately, with the enjoyment or the use of property. This would not prove, even if no others were then known, that the forms then accepted were not subject to enlargement. *Cf. Pensacola Teleg. Co. v. Western Union Telegraph Co.*, 96 U.S. 1, 9; *In re Debs,* 158 U.S. 564, 591; *South Carolina v. United States,* 199 U.S. 437, 448, 449. But in truth other excises were known, and known since early times. . . .

The historical prop failing, the prop or fancied prop of principle remains. We learn that employment for lawful gain is a "natural" or "inherent" or "inalienable" right, and not a "privilege" at all. But natural rights, so called, are as much subject to taxation as rights of less importance.[1] An excise is not limited to vocations or activities that may be prohibited altogether. It is not limited to those that are the outcome of a franchise. It extends to vocations or activities pursued as of common right. What the individual does in the operation of a business is amenable to taxation just as much as what he owns, at all events if the classification is not tyrannical or arbitrary. . . .

2. The tax being an excise, its imposition must conform to the canon of uniformity. There has been no departure from this requirement. According to the settled doctrine, the uniformity exacted is geographical, not intrinsic. . . .

Second. The excise is not invalid under the provisions of the Fifth Amendment by force of its exemptions.

The statute does not apply, as we have seen, to employers of less than eight. It does not apply to agricultural labor, or domestic service in a private home or to some other classes of less importance. Petitioner contends that the effect of these restrictions is an arbitrary discrimination vitiating the tax.

The Fifth Amendment unlike the Fourteenth has no equal protection clause. *LaBelle Iron Works v. United States, supra; Brushaber v. Union Pacific R. R. Co., supra,* 240 U.S. 1, at page 24. But even the states, though subject to such a clause, are not confined to a formula of rigid uniformity in framing measures of taxation. *Swiss Oil Corporation v. Shanks,* 273 U.S. 407, 413. They may tax some kinds of property at one rate, and others at another, and exempt others altogether. *Bell's Gap R. R. Co. v. Pennsylvania,* 134 U.S. 232; *Stebbins v. Riley,* 268 U.S. 137, 142; *Ohio Oil Co. v. Conway,* 281 U.S. 146, 150. They may lay an excise on the operations of a particular kind of business, and exempt some other kind of business closely akin thereto. *Quong Wing v.*

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[1] The cases are brought together by Prof. John MacArthur Maguire in an essay, "Taxing the Exercise of Natural Rights" (Harvard Legal Essays, 1934, pp. 273, 322). . . .

Kirkendall, 223 U.S. 59, 62; *American Sugar Refining Co. v. Louisiana*, 179 U.S. 89, 94; *Armour Packing Co. v. Lacy*, 200 U. S. 226, 235; *Brown-Forman Co. v. Kentucky*, 217 U.S. 563, 573; *Heisler v. Thomas Colliery Co.*, 260 U.S. 245, 255; *State Board of Tax Com'rs v. Jackson*, 283 U.S. 527, 537, 538. If this latitude of judgment is lawful for the states, it is lawful, *a fortiori*, in legislation by the Congress, which is subject to restraints less narrow and confining. *Quong Wing v. Kirkendall, supra*. . . .

Third. The excise is not void as involving the coercion of the states in contravention of the Tenth Amendment or of restrictions implicit in our federal form of government.

The proceeds of the excise when collected are paid into the Treasury at Washington, and thereafter are subject to appropriation like public moneys generally. *Cincinnati Soap Co. v. United States*, 301 U.S. 308. No presumption can be indulged that they will be misapplied or wasted. Even if they were collected in the hope or expectation that some other and collateral good would be furthered as an incident, that without more would not make the act invalid. *Sonzinsky v. United States*, 300 U.S. 506. This indeed is hardly questioned. The case for the petitioner is built on the contention that here an ulterior aim is wrought into the very structure of the act, and what is even more important that the aim is not only ulterior, but essentially unlawful. In particular, the 90 per cent. credit is relied upon as supporting that conclusion. But before the statute succumbs to an assault upon these lines, two propositions must be made out by the assailant. *Cincinnati Soap Co. v. United States, supra*. There must be a showing in the first place that separated from the credit the revenue provisions are incapable of standing by themselves. There must be a showing in the second place that the tax and the credit in combination are weapons of coercion, destroying or impairing the autonomy of the states. The truth of each proposition being essential to the success of the assault, we pass for convenience to a consideration of the second, without pausing to inquire whether there has been a demonstration of the first.

To draw the line intelligently between duress and inducement, there is no need to remind ourselves of facts as to the problem of unemployment that are now matters of common knowledge. *West Coast Hotel Co. v. Parrish*, 300 U.S. 379. The relevant statistics are gathered in the brief of counsel for the government. Of the many available figures a few only will be mentioned. During the years 1929 to 1936, when the country was passing through a cyclical depression, the number of the unemployed mounted to unprecedented heights. Often the average was more than 10 million; at times a peak was attained of 16 million or more. Disaster to the breadwinner meant disaster to dependents. Accordingly the roll of the unemployed, itself formidable enough, was

only a partial roll of the destitute or needy. The fact developed quickly that the states were unable to give the requisite relief. The problem had become national in area and dimensions. There was need of help from the nation if the people were not to starve. It is too late today for the argument to be heard with tolerance that in a crisis so extreme the use of the moneys of the nation to relieve the unemployed and their dependents is a use for any purpose narrower than the promotion of the general welfare. *Cf. United States v. Butler,* 297 U.S. 1, 65, 66; *Helvering v. Davis,* 301 U.S. 619, decided herewith. The nation responded to the call of the distressed. Between January 1, 1933, and July 1, 1936, the states (according to statistics submitted by the government) incurred obligations of $689,291,802 for emergency relief; local subdivisions an additional $775,675,366. In the same period the obligations for emergency relief incurred by the national government were $2,929,307,125, or twice the obligations of states and local agencies combined. According to the President's budget message for the fiscal year 1938, the national government expended for public works and unemployment relief for the three fiscal years 1934, 1935, and 1936, the stupendous total of $8,681,000,000. The *parens patriae* has many reasons—fiscal and economic as well as social and moral—for planning to mitigate disasters that bring these burdens in their train.

In the presence of this urgent need for some remedial expedient, the question is to be answered whether the expedient adopted has overlept the bounds of power. The assailants of the statute say that its dominant end and aim is to drive the state Legislatures under the whip of economic pressure into the enactment of unemployment compensation laws at the bidding of the central government. Supporters of the statute say that its operation is not constraint, but the creation of a larger freedom, the states and the nation joining in a co-operative endeavor to avert a common evil. Before Congress acted, unemployment compensation insurance was still, for the most part, a project and no more. Wisconsin was the pioneer. Her statute was adopted in 1931. At times bills for such insurance were introduced elsewhere, but they did not reach the stage of law. In 1935, four states (California, Massachusetts, New Hampshire, and New York) passed unemployment laws on the eve of the adoption of the Social Security Act, and two others did likewise after the federal act and later in the year. The statutes differed to some extent in type, but were directed to a common end. In 1936, twenty-eight other states fell in line, and eight more the present year. But if states had been holding back before the passage of the federal law, inaction was not owing, for the most part, to the lack of sympathetic interest. Many held back through alarm lest in laying such a toll upon their industries, they would place themselves in

a position of economic disadvantage as compared with neighbors or competitors. See House Report, No. 615, 74th Congress, 1st session, p. 8; Senate Report, No. 628, 74th Congress, 1st session, p. 11.[2] Two consequences ensued. One was that the freedom of a state to contribute its fair share to the solution of a national problem was paralyzed by fear. The other was that in so far as there was failure by the states to contribute relief according to the measure of their capacity, a disproportionate burden, and a mountainous one, was laid upon the resources of the government of the nation.

The Social Security Act is an attempt to find a method by which all these public agencies may work together to a common end. Every dollar of the new taxes will continue in all likelihood to be used and needed by the nation as long as states are unwilling, whether through timidity or for other motives, to do what can be done at home. At least the inference is permissible that Congress so believed, though retaining undiminished freedom to spend the money as it pleased. On the other hand, fulfillment of the home duty will be lightened and encouraged by crediting the taxpayer upon his account with the Treasury of the nation to the extent that his contributions under the laws of the locality have simplified or diminished the problem of relief and the probable demand upon the resources of the fisc. Duplicated taxes, or burdens that approach them are recognized hardships that government, state or national, may properly avoid. *Henneford v. Silas Mason Co., Inc., supra; Kidd v. Alabama,* 188 U.S. 730, 732; *Watson v. State Comptroller,* 254 U.S. 122, 125. If Congress believed that the general welfare would better be promoted by relief through local units than by the system then in vogue, the co-operating localities ought not in all fairness to pay a second time.

Who then is coerced through the operation of this statute? Not the taxpayer. He pays in fulfillment of the mandate of the local legislature. Not the state. Even now she does not offer a suggestion that in passing the unemployment law she was affected by duress. For all that appears, she is satisfied with her choice, and would be sorely disappointed if it were now to be annulled. The difficulty with the petitioner's contention is that it confuses motive with coercion. "Every tax is in some measure regulatory.

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[2] The attitude of Massachusetts is significant. Her act became a law August 12, 1935, two days before the federal act. Even so, she prescribed that its provisions should not become operative unless the federal bill became a law, or unless eleven of the following states (Alabama, Connecticut, Delaware, Georgia, Illinois, Indiana, Iowa, Maine, Maryland, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New York, North Carolina, Ohio, Rhode Island, South Carolina, Tennessee, Vermont) should impose on their employers burdens substantially equivalent. St. of 1935, c. 479, p. 655. Her fear of competition is thus forcefully attested. See, also, California St. 1935, c. 352, art. 1, sec. 2; Idaho Laws 1936 (Third Extra Session) c. 12, sec. 26; Mississippi Laws 1936, c. 176, sec. 2–a.

To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed." *Sonzinsky v. United States, supra.* . . .

United States v. Butler, supra, is cited by petitioner as a decision to the contrary. There a tax was imposed on processors of farm products, the proceeds to be paid to farmers who would reduce their acreage and crops under agreements with the Secretary of Agriculture, the plan of the act being to increase the prices of certain farm products by decreasing the quantities produced. The court held (1) that the so-called tax was not a true one (297 U.S. 1, at pages 56, 61), the proceeds being earmarked for the benefit of farmers complying with the prescribed conditions, (2) that there was an attempt to regulate production without the consent of the state in which production was affected, and (3) that the payments to farmers were coupled with coercive contracts (297 U.S. 1, at page 73), unlawful in their aim and oppressive in their consequences. The decision was by a divided court, a minority taking the view that the objections were untenable. None of them is applicable to the situation here developed.

(a) The proceeds of the tax in controversy are not earmarked for a special group.

(b) The unemployment compensation law which is a condition of the credit has had the approval of the state and could not be a law without it.

(c) The condition is not linked to an irrevocable agreement, for the state at its pleasure may repeal its unemployment law (section 903(a) (6)), terminate the credit, and place itself where it was before the credit was accepted.

(d) The condition is not directed to the attainment of an unlawful end, but to an end, the relief of unemployment, for which nation and state may lawfully coöperate. . . .[3]

The judgment is *Affirmed.*

Dissenting opinions of JUSTICES MCREYNOLDS, SUTHERLAND, and BUTLER, in which MR. JUSTICE VAN DEVANTER concurred, are omitted.

Notes

At the same time, the Court decided *Helvering v. Davis,* 301 U.S. 619 (1937), upholding the employment taxes imposed by Title VIII of the Social Security Act, designed to provide for the payment of old age benefits. These taxes are now found in sections 3101–3125 of the Internal Revenue Code of 1954.

In *Cincinnati Soap Co. v. United States,* 301 U.S. 308 (1937), the Court upheld section 602½ of the Revenue Act of 1934 which

[3] The portion of the opinion dealing with the requirement that state laws be approved, and that state funds be deposited in the federal treasury, is omitted.

imposed a tax on the first domestic processing of coconut oil, and directed that the tax collected with respect to oil of Philippine production should be held as a separate fund and paid to the Philippine Treasury, "but if at any time the Philippine Government provides by any law for any subsidy to be paid to the producers of copra, coconut oil, or allied products, no further payments to the Philippine Treasury shall be made under this subsection."

UNITED STATES v. KAHRIGER

Supreme Court of the United States, 1953. 345 U.S. 22.

MR. JUSTICE REED delivered the opinion of the Court.

The issue raised by this appeal is the constitutionality of the occupational tax provisions of the Revenue Act of 1951, which levy a tax on persons engaged in the business of accepting wagers, and require such persons to register with the Collector of Internal Revenue. The unconstitutionality of the tax is asserted on two grounds. First, it is said that Congress, under the pretense of exercising its power to tax has attempted to penalize illegal intrastate gambling through the regulatory features of the Act (26 U.S.C. (Supp. V) § 3291) and has thus infringed the police power which is reserved to the states. Secondly, it is urged that the registration provisions of the tax violate the privilege against self-incrimination and are arbitrary and vague, contrary to the guarantees of the Fifth Amendment.

The case comes here on appeal, in accordance with 18 U.S.C. § 3731, from the United States District Court for the Eastern District of Pennsylvania, where an information was filed against appellee alleging that he was in the business of accepting wagers and that he willfully failed to register for and pay the occupational tax in question. Appellee moved to dismiss on the ground that the sections upon which the indictment was based were unconstitutional. The District Court sustained the motion on the authority of our opinion in *United States v. Constantine*, 296 U.S. 287. The court reasoned that "while the subject matter of this legislation so far as revenue purposes is concerned is within the scope of Federal authorities," the tax was unconstitutional in that the information called for by the registration provisions was "peculiarly applicable to the applicant from the standpoint of law enforcement and vice control," and therefore the whole of the legislation was an infringement by the Federal Government on the police power reserved to the states by the Tenth Amendment. *United States v. Kahriger*, 105 F.Supp. 322, 323.

The result below is at odds with the position of the seven other district courts which have considered the matter, and, in our opinion, is erroneous.

In the term following the *Constantine* opinion, this Court pointed out in *Sonzinsky v. United States*, 300 U.S. 506, at 513 (a case involving a tax on a "limited class" of objectionable firearms alleged to be prohibitory in effect and "to disclose unmistakably the legislative purpose to regulate rather than to tax"), that the subject of the tax in *Constantine* was "described or treated as criminal by the taxing statute." The tax in the *Constantine* case was a special additional excise tax of $1,000, placed only on persons who carried on a liquor business in violation of state law. The wagering tax with which we are here concerned applies to all persons engaged in the business of receiving wagers regardless of whether such activity violates state law.

The substance of respondent's position with respect to the Tenth Amendment is that Congress has chosen to tax a specified business which is not within its power to regulate. The precedents are many upholding taxes similar to this wagering tax as a proper exercise of the federal taxing power. In the *License Tax Cases*, 5 Wall. 462, the controversy arose out of indictments for selling lottery tickets and retailing liquor in various states without having first obtained and paid for a license under the Internal Revenue Act of Congress. The objecting taxpayers urged that Congress could not constitutionally tax or regulate activities carried on within a state. P. 470. The Court pointed out that Congress had "no power of regulation nor any direct control" (5 Wall., at 471, 472) over the business there involved. The Court said if the licenses were to be regarded as by themselves giving authority to carry on the licensed business it might be impossible to reconcile the granting of them with the Constitution. P. 471.

> "But it is not necessary to regard these laws as giving such authority. So far as they relate to trade within State limits, they give none, and can give none. They simply express the purpose of the government not to interfere by penal proceedings with the trade nominally licensed, if the required taxes are paid. The power to tax is not questioned, nor the power to impose penalties for non-payment of taxes. The granting of a license, therefore, must be regarded as nothing more than a mere form of imposing a tax, and of implying nothing except that the licensee shall be subject to no penalties under national law, if he pays it." *Id.*, at 471.

Appellee would have us say that because there is legislative history indicating a congressional motive to suppress wagering, this tax is not a proper exercise of such taxing power. In the *License Cases, supra,* it was admitted that the federal license "discouraged" the activities. The intent to curtail and hinder,

as well as tax, was also manifest in the following cases, and in each of them the tax was upheld: *Veazie Bank v. Fenno*, 8 Wall. 533 (tax on paper money issued by state banks); *McCray v. United States*, 195 U.S. 27, 59 (tax on colored oleomargarine); *United States v. Doremus*, 249 U.S. 86, and *Nigro v. United States*, 276 U.S. 332 (tax on narcotics); *Sonzinsky v. United States*, 300 U.S. 506 (tax on firearms); *United States v. Sanchez*, 340 U.S. 42 (tax on marihuana).

It is conceded that a federal excise tax does not cease to be valid merely because it discourages or deters the activities taxed. Nor is the tax invalid because the revenue obtained is negligible. Appellee, however, argues that the sole purpose of the statute is to penalize only illegal gambling in the states through the guise of a tax measure. As with the above excise taxes which we have held to be valid, the instant tax has a regulatory effect. But regardless of its regulatory effect, the wagering tax produces revenue. As such it surpasses both the narcotics and firearms taxes which we have found valid.[4]

It is axiomatic that the power of Congress to tax is extensive and sometimes falls with crushing effect on businesses deemed unessential or inimical to the public welfare, or where, as in dealings with narcotics, the collection of the tax also is difficult. As is well known, the constitutional restraints on taxing are few. "Congress cannot tax exports, and it must impose direct taxes by the rule of apportionment and indirect taxes by the rule of uniformity." *License Tax Cases, supra*, 471. The remedy for excessive taxation is in the hands of Congress, not the courts. *Veazie Bank v. Fenno*, 8 Wall. 533, 548. Speaking of the creation of the Bank of the United States, as an instrument for carrying out federal fiscal policies, this Court said in *McCulloch v. Maryland*, 4 Wheat. 316, 423:

> "Should Congress, in the execution of its powers, adopt measures which are prohibited by the constitution; or should Congress, under the pretext of executing its powers, pass laws for the accomplishment of objects not entrusted to the government; it would become the painful duty of this tribunal, should a case requiring such a decision come before it, to say that such an act was not the law of the land. But

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[4] One of the indicia which appellee offers to support his contention that the wagering tax is not a proper revenue measure is that the tax amount collected under it was $4,371,869 as compared with an expected amount of $400,000,000 a year. The figure of $4,371,869, however, is relatively large when it is compared with the $3,501 collected under the tax on adulterated and process or renovated butter and filled cheese, the $914,910 collected under the tax on narcotics, including marihuana and special taxes, and the $28,911 collected under the tax on firearms transfer and occupational taxes. (Summary of Internal Revenue Collections, released by Bureau of Internal Revenue, October 3, 1952.)

> where the law is not prohibited, and is really calculated to effect any of the objects entrusted to the government, to undertake here to inquire into the degree of its necessity, would be to pass the line which circumscribes the judicial department, and to tread on legislative ground. This court disclaims all pretentions to such a power."

The difficulty of saying when the power to lay uniform taxes is curtailed, because its use brings a result beyond the direct legislative power of Congress, has given rise to diverse decisions. In that area of abstract ideas, a final definition of the line between state and federal power has baffled judges and legislators.

While the Court has never questioned the above-quoted statement of Mr. Chief Justice Marshall in the *Bank* case, the application of the rule has brought varying holdings on constitutionality. Where federal legislation has rested on other congressional powers, such as the Necessary and Proper Clause or the Commerce Clause, this Court has generally sustained the statutes, despite their effect on matters ordinarily considered state concern. When federal power to regulate is found, its exercise is a matter for Congress.[5] Where Congress has employed the taxing clause a greater variation in the decisions has resulted. The division in this Court has been more acute. Without any specific differentiation between the power to tax and other federal powers, the indirect results from the exercise of the power to tax have raised more doubts. This is strikingly

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[5] McCulloch v. Maryland, 4 Wheat. 316, 472, upheld the creation of a bank under the necessary and proper clause. Veazie Bank v. Fenno, 8 Wall. 533, 548, depends partly on the alternate ground of the federal power to provide money for circulation. In re Rapier, 143 U.S. 111, the use of the mails by papers that advertised the Louisiana Lottery was barred. The Lottery Case, 188 U.S. 321, approved the same result through the commerce power. That power was enough to bar transportation of pictures of prize fights, Weber v. Freed, 239 U.S. 325; to seize contraband eggs after shipment had ended, Hipolite Egg Co. v. United States, 220 U.S. 45, 56; and to bar transportation of women for immoral purposes, Caminetti v. United States, 242 U.S. 470. While in United States v. Butler, 297 U.S. 1, 68, 73, a use of a tax for regulation was disapproved, an enactment that resulted in regulation under the Commerce Clause met judicial favor. Mulford v. Smith, 307 U.S. 38, 47; Wickard v. Filburn, 317 U.S. 111. Hill v. Wallace, 259 U.S. 44, 67, and Trusler v. Crooks, 269 U.S. 475, based on taxation, held taxes that regulated the grain markets were unconstitutional as an interference with state power. In Chicago Board of Trade v. Olsen, 262 U.S. 4, regulations based on the Commerce Clause were upheld. The departure from this line of decisions in Hammer v. Dagenhart, 247 U.S. 251, was reversed in United States v. Darby, 312 U.S. 100, 115–124, where we said:

"Whatever their motive and purpose, regulations of commerce which do not infringe some constitutional prohibition are within the plenary power conferred on Congress by the Commerce Clause." Id., at 115. "The power of Congress over interstate commerce . . . extends to those activities intrastate which so affect interstate commerce or the exercise of the power of Congress over it as to make regulation of them appropriate means to the attainment of a legitimate end, the exercise of the granted power of Congress to regulate interstate commerce." Id., at 118.

illustrated by the shifting course of adjudication in taxation of the handling of narcotics.[6] The tax ground in the *Veazie Bank* case, *supra*, recognized that strictly state governmental activities such as the right to pass laws were beyond the federal taxing power.[7] That case allowed a tax, however, that obliterated from circulation all state bank notes. A reason was that "the judicial cannot prescribe to the legislative departments of the government limitations upon the exercise of its acknowledged powers." *Id.*, at 548. The tax cases cited above in the third preceding paragraph followed that theory. It is hard to understand why the power to tax should raise more doubts because of indirect effects than other federal powers.[9]

Penalty provisions in tax statutes added for breach of a regulation concerning activities in themselves subject only to state regulation have caused this Court to declare the enactments invalid.[10] Unless there are provisions, extraneous to any tax need, courts are without authority to limit the exercise of the taxing power.[11] All the provisions of this excise are adapted to the collection of a valid tax.

Nor do we find the registration requirements of the wagering tax offensive. All that is required is the filing of names, addresses, and places of business. This is quite general in tax returns.[12] Such data are directly and intimately related to the collection of the tax and are "obviously supportable as in aid of a revenue purpose." *Sonzinsky v. United States,* 300 U.S. 506, at 513. The registration provisions make the tax simpler to collect. . . .

Reversed.

[A concurring opinion by MR. JUSTICE JACKSON is omitted. A dissenting opinion by JUSTICES BLACK and DOUGLAS is likewise omitted.]

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6 United States v. Jin Fuey Moy, 241 U.S. 394, 402; United States v. Doremus, 249 U.S. 86; Linder v. United States, 268 U.S. 5; Nigro v. United States, 276 U.S. 332.

7 Cf. New York v. United States, 326 U.S. 572, 582, 587–588.

9 Cf. McCulloch v. Maryland, 4 Wheat., at 422.

10 Child Labor Tax Case, 259 U.S. 20, 34, 38; Hill v. Wallace, 259 U.S. 44, 63, 70; United States v. Constantine, 296 U.S. 287.

11 But see Linder v. United States, 268 U.S. 5, 18; Trusler v. Crooks, 269 U.S. 475.

12 26 U.S.C. § 2011 et seq., require registration by tobacco manufacturers, dealers and peddlers of the "name, or style, place of residence, trade, or business, and place where such trade or business is to be carried on." 26 U.S.C. § 2810 requires the possessor of distilling apparatus to register "the particular place where such still or distilling apparatus is set up . . . the owner thereof, his place of residence . . . ." See also 26 U.S.C. § 3270.

MR. JUSTICE FRANKFURTER, dissenting.

The Court's opinion manifests a natural difficulty in reaching its conclusion. Constitutional issues are likely to arise whenever Congress draws on the taxing power not to raise revenue but to regulate conduct. This is so, of course, because of the distribution of legislative power as between the Congress and the State Legislatures in the regulation of conduct.

To review in detail the decisions of this Court, beginning with *Veazie Bank v. Fenno*, 8 Wall. 533, dealing with this ambivalent type of revenue enactment, would be to rehash the familiar. Two generalizations may, however, safely be drawn from this series of cases. Congress may make an oblique use of the taxing power in relation to activities with which Congress may deal directly, as for instance, commerce between the States. Thus, if the dissenting views of Mr. Justice Holmes in *Hammer v. Dagenhart*, 247 U.S. 251, 277, had been the decision of the Court, as they became in *United States v. Darby*, 312 U.S. 100, the effort to deal with the problem of child labor through an assertion of the taxing power in the statute considered in *Child Labor Tax Case*, 259 U.S. 20, would by the latter case have been sustained. However, when oblique use is made of the taxing power as to matters which substantively are not within the powers delegated to Congress, the Court cannot shut its eyes to what is obviously, because designedly, an attempt to control conduct which the Constitution left to the responsibility of the States, merely because Congress wrapped the legislation in the verbal cellophane of a revenue measure.

Concededly the constitutional questions presented by such legislation are difficult. On the one hand, courts should scrupulously abstain from hobbling congressional choice of policies, particularly when the vast reach of the taxing power is concerned. On the other hand, to allow what otherwise is excluded from congressional authority to be brought within it by casting legislation in the form of a revenue measure could, as so significantly expounded in the *Child Labor Tax Case, supra*, offer an easy way for the legislative imagination to control "any one of the great number of subjects of public interest, jurisdiction of which the States have never parted with. . . ." *Child Labor Tax Case*, at 38. I say "significantly" because Mr. Justice Holmes and two of the Justices who had joined his dissent in *Hammer v. Dagenhart*, McKenna and Brandeis, JJ., agreed with the opinion in the *Child Labor Tax Case*. Issues of such gravity affecting the balance of powers within our federal system are not susceptible of comprehensive statement by smooth formulas such as that a tax is nonetheless a tax although it discourages the activities taxed, or, that a tax may be imposed although it may effect

ulterior ends. No such phrase, however fine and well-worn, enables one to decide the concrete case.

What is relevant to judgment here is that, even if the history of this legislation as it went through Congress did not give one the libretto to the song, the context of the circumstances which brought forth this enactment—sensationally exploited disclosures regarding gambling in big cities and small, the relation of this gambling to corrupt politics, the impatient public response to these disclosures, the feeling of ineptitude or paralysis on the part of local law-enforcing agencies—emphatically supports what was revealed on the floor of Congress, namely, that what was formally a means of raising revenue for the Federal Government was essentially an effort to check if not to stamp out professional gambling.

A nominal taxing measure must be found an inadmissible intrusion into a domain of legislation reserved for the States not merely when Congress requires that such a measure is to be enforced through a detailed scheme of administration beyond the obvious fiscal needs, as in the *Child Labor Tax Case, supra.* That is one ground for holding that Congress was constitutionally disrespectful of what is reserved to the States. Another basis for deeming such a formal revenue measure inadmissible is presented by this case. In addition to the fact that Congress was concerned with activity beyond the authority of the Federal Government to deal with, the enforcing provision of this enactment is designed for the systematic confession of crimes with a view to prosecution for such crimes under State law.

It is one thing to hold that the exception, which the Fifth Amendment makes to the duty of a witness to give his testimony when relevant to a proceeding in a federal court, does not include the potential danger to that witness of possible prosecution in a State court, *Brown v. Walker,* 161 U.S. 591, 606, and, conversely, that the Fifth Amendment does not enable States to give immunity from use in federal courts of testimony given in a State court. *Feldman v. United States,* 322 U.S. 487. It is a wholly different thing to hold that Congress, which cannot constitutionally grapple directly with gambling in the States, may compel self-incriminating disclosures for the enforcement of State gambling laws, merely because it does so under the guise of a revenue measure obviously passed not for revenue purposes. The motive of congressional legislation is not for our scrutiny, provided only that the ulterior purpose is not expressed in ways which negative what the revenue words on their face express and, as in this case, which do not seek enforcement of the formal revenue purpose through means that offend those standards of decency in our civilization against which due process is a barrier.

I would affirm this judgment.

MR. JUSTICE DOUGLAS, while not joining in the entire opinion, agrees with the views expressed herein that this tax is an attempt by the Congress to control conduct which the Constitution has left to the responsibility of the States.

Note

See Landman, "Government's Hypocrisy in Gambling," 34 Taxes 107 (1956); Chenoweth, "A Judicial Balance Sheet for the Federal Gambling Tax," 53 Northwestern U.L.Rev. 457 (1958).

Ethical Problems

Any lawyer must be aware of ethical considerations in his practice, and this is surely no less true of tax lawyers, or of lawyers in general practice who handle a tax case. Discussions of the types of questions which may arise may be found in Maguire, "Conscience and Propriety in Tax Practice," 13 Tax L.Rev. 27 (1957); "Ethical Problems of Tax Practitioners," 8 Tax L.Rev. 1 (1952); Lawyers' Problems of Conscience 1 (Harvard Student Bar Association 1953); Paul, "The Lawyer as a Tax Adviser," 25 Rocky Mountain L.Rev. 412 (1953); Miller, "Morality in Tax Planning," in N.Y.Univ. Tenth Annual Institute on Federal Taxation 1067 (1952). Cf. Hawley, "Morality vs. Legality," 27 Pa.Bar Ass'n Q. 230 (1956).

CHAPTER 2

THE ELEMENTS OF FEDERAL TAX PROCEDURE

The law schools should be the first to recognize that the last place to learn the ins and outs of procedure is in the law schools. That is not the object of this Chapter. Some knowledge of the procedural background of tax cases is, however, essential to an understanding of the substantive questions which they present. A general knowledge of the structure of the federal courts system is, naturally, assumed.

The procedure followed in a federal tax case varies largely according to whether (1) the taxpayer is trying to obtain a refund, or (2) the Government is seeking to collect a deficiency. Until 1924, this distinction did not exist. Before that time, the only way a taxpayer could get a judicial review of a tax controversy was by paying the tax and suing to get it back. This is still true of all taxes other than income, estate, gift, and excess profits taxes.

Questions of Federal tax practice and procedure are fully treated in Bickford, Successful Tax Practice (2d ed. 1952), and Casey, Federal Tax Practice (1955), in four volumes.

Over the past several years, there has been a very complete reorganization of the Treasury Department's machinery for the administration of the Internal Revenue laws.

From the time of the Civil War, the agency charged with collecting internal taxes was known as the Bureau of Internal Revenue. Its principal officer was (and is) the Commissioner of Internal Revenue, who is nominated by the President and confirmed by the Senate. The Bureau had a number of administrative officers in Washington, and also a number of officers in the field. In more recent years, the latter were divided into three more or less separate groups. These were:

(1) The *collectors of internal revenue.* There was at least one collector in each state, and some states had two or more collection districts, with a collector in charge of each. The collectors were political officers, nominated by the President, and confirmed by the Senate. They in turn appointed a considerable number of deputy collectors. The functions of the collector and his deputies were chiefly ministerial—to accept returns and re-

ceive payment of tax, keep the books, send out bills for taxes, and collect delinquent taxes which had been assessed by the Commissioner.

(2) The *internal revenue agents in charge.* Each of these officers had a large number of revenue agents on his staff. Their function was to audit returns, carry on investigations, negotiate with taxpayers in cases of difference of opinion, settle cases which could be settled, and determine tax liabilities, as far as the Treasury was concerned, where agreement could not be reached.

(3) The *Technical Staff.* This was a group of experienced tax officers who gave an administrative appellate review in cases where the taxpayer sought such a review. This review might be given either before or after a case was taken to the Tax Court of the United States.

Over all of this was the Bureau organization in Washington. Although there was a considerable amount of decentralization, particularly after 1936, the officials in Washington kept fairly close control over all aspects of the tax collecting operations.[1]

This organization is outlined here because many of the cases in this book involve collectors of internal revenue, and the student may encounter other references to the old organization in connection with his work in the tax field.

Since 1952, there have been extensive changes in the organization. These have introduced a greater measure of decentralization from Washington control, and more coordination among the field offices. The changes have occurred as a result of a number of separate orders, and there has been a certain amount of backing and filling during the period of transition. It is not necessary to detail here all of the steps by which the changes have been made.

The first and most important change came about through an exercise of the power of the President under the authority of the Reorganization Act of 1949, c. 226, Title I, 63 Stat. 203. On January 14, 1952, the President issued Reorganization Plan No. 1 of 1952, which is published in 17 Federal Register 2243. Under the terms of the statute, the President's Reorganization Order became effective when it was not disapproved by Congress. The Plan abolished the office of collector of internal revenue, and set up an officer who was for a while known as the Director of Internal Revenue. The title of this office was soon changed

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1 The most complete exposition of the older organization and procedure is found in the Monograph on Administration of Internal Revenue Laws, of the Attorney General's Committee on Administrative Procedure (1941). This was published as Part 9 of Senate Doc. No. 10, 77th Congress, First Session. It is summarized in Armstrong, "Administration of Internal Revenue Laws," 18 Taxes 516 (1940).

to District Director of Internal Revenue. (Treas. Dept. Order No. 150–26, issued June 15, 1953.) The District Director is appointed administratively, and under the direction of the Civil Service Commission. He has charge of all of the Internal Revenue operations in his area, including the collecting function, and the audit of returns and negotiations with taxpayers.

The District Directors' offices are organized into nine Internal Revenue Regions, each headed by a Regional Commissioner of Internal Revenue. One of the offices in the Regional Commissioner's organization is known as the Appellate Division. It takes over the administrative appellate functions formerly handled by the Technical Staff.[2]

Finally, the name of the Bureau of Internal Revenue itself was changed. It is now the Internal Revenue Service. This change was made by an order of the Secretary of the Treasury (Treas. Dept. Order No. 150–29) issued on July 9, 1953. The entire organization is still in charge of the Commissioner of Internal Revenue, and it is common, when referring to an official action of the Internal Revenue officers to say that it was done by "the Commissioner."

This new organization is unaffected by the Internal Revenue Code of 1954. In general, under the new statute, authority is expressly given, in many places, "to the Secretary or his delegate." By a series of orders, the power of the Secretary with respect to Internal Revenue taxes has been delegated to the Commissioner, and the Commissioner has in turn delegated his authority to various officers in the Internal Revenue Service, in accordance with the scheme of organization. See secs. 7801–7809 of the Internal Revenue Code of 1954.

A. GENERAL

ALLEN v. REGENTS OF THE UNIVERSITY SYSTEM OF GEORGIA

Supreme Court of the United States, 1938. 304 U.S. 439.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The question on the merits is whether the exaction of the federal admissions tax, in respect of athletic contests in which teams representing colleges conducted by the respondent participate,

[2] Early treatments of the new organization may be found in Bickford, Bureau of Internal Revenue Organization (1952); Goodrich and Redman, Procedure Before the Bureau of Internal Revenue (2d ed. 1953); Miller, "The Reorganization of the Bureau of Internal Revenue—an Appraisal," 30 Taxes 967 (1952). See also Spencer, "Tax Practice and Procedure in the Collectors' Offices," 30 Taxes 120 (1952); Surrey, "A Comment on the Proposal to Separate the Bureau of Internal Revenue from the Treasury Department," 8 Tax L.Rev. 155 (1953).

unconstitutionally burdens a governmental function of the State of Georgia. The petition also challenges the respondent's ability to maintain a suit to enjoin the collection of the tax and to substitute as defendant the successor in office of the Collector originally impleaded. The court below decided all the questions involved against the petitioner.[1] Because of their importance we granted certiorari.

Section 500(a) (1) of the Revenue Act of 1926, as amended by Section 711 of the Revenue Act of 1932 imposes "a tax of 1 cent for each 10 cents or fraction thereof of the amount paid for admission to any place . . . to be paid by the person paying for such admission; . . ." Subsection (d) commands that the price (exclusive of the tax to be paid by the person paying for admission) at which every admission ticket is sold shall be conspicuously printed, stamped, or written on the face or back of that portion of the ticket which is to be taken up by the management and imposes a penalty for failure to comply with its terms. Section 502 requires the person receiving payments for admissions to collect the tax and make return in such form as the Commissioner of Internal Revenue may prescribe by regulation. Section 1102(a) imposes the duty on persons who collect the tax to keep records and render statements, under oath, and to make returns as required by the Secretary of the Treasury. Section 1114(b) and (d) fixes penalties for failure to collect or pay over and subsection (e) provides for the personal liability of one collecting the admission charge and for distraint by the Collector of Internal Revenue for taxes and penalties. Section 607 of the Revenue Act of 1934 requires the person charged with the collection of the tax to hold the amount collected as a special fund in trust for the United States, confers the right to assess him with the amount so collected and withheld, including penalties, and, in connection with R.S. 3187, authorizes the Collector of Internal Revenue to distrain therefor.

The respondent is a public corporation, created by Georgia as an instrumentality of the State, having control and management of the University of Georgia and the Georgia School of Technology. Athletics at these institutions are conducted under the respondent's authority by two corporations, the University of Georgia Athletic Association and the Georgia Tech. Athletic Association. The expense of physical education and athletic programs at each school is defrayed almost entirely from the ad-

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[1] The defendant in the District Court was W. E. Page, the petitioner's predecessor in office. That court dismissed the bill. 10 F.Supp. 901. The Circuit Court of Appeals reversed. 81 F.2d 577. After answer and a hearing on the merits the District Court awarded an injunction. 18 F.Supp. 62. The Circuit Court of Appeals permitted the substitution of the petitioner for Page and affirmed the decree by a divided court. 93 F.2d 887.

mission charges to athletic contests and students' athletic fees collected for the purpose. During September and October 1934 football games were played at the institutions, for which admissions were charged and collected by the associations. Each ticket showed on its face the admission price, the amount of the tax, and the total of the two, and also carried the following printed notice:

"The University of Georgia [or Georgia School of Technology] being an instrumentality of the government of the State of Georgia, contends that it is not liable for any admission tax. The amount stated as a tax is so stated because the University is required to do so by Treasury regulations pending a decision as to its liability in this respect. This amount is collected by the University as a part of the admission and will be retained as such unless it is finally determined that the University is itself liable for the tax."

Each association deposited the total collected as the disputed tax in a separate bank account, apart from its other funds, but made no return thereof. The Collector prepared returns for the amounts. In consequence of the associations' neglect to pay the amounts so returned, the Commissioner assessed each association in the amount shown by return made for it and certified the assessments to the Collector who made demands for payment. These were ignored and the Collector filed liens, issued warrants, and levied upon the deposit accounts. The respondent then brought suit in which it prayed a decree that, as an agency of the State performing an essential governmental function in the conduct of the games, it was immune from the tax, and sought injunctions, temporary and permanent, to restrain the Collector from proceeding further to collect the sums demanded. From a decree awarding a final injunction the Collector appealed but pending appeal, resigned and, before the hearing, died. Over objection the Circuit Court of Appeals ordered the petitioner substituted as appellant and affirmed the decree. We are of opinion that the court below rightly decided the procedural questions but erred as to the merits.[2]

Second. If the tax, the collection of which was threatened, constituted an inadmissible burden upon a governmental activity of the State, the circumstances disclosed render the cause one of equitable cognizance and take it out of the prohibition of R.S. 3224.[3] The respondent has long been of opinion that exaction of the tax in respect of games played under the auspices of The University of Georgia and the Georgia School of Technology con-

[2] The next portion of the opinion, holding that the successor collector was properly substituted, is omitted.

[3] "No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court." U.S.C. Tit. 26, sec. 1543. [This is now found without change in section 7421(a) of the Internal Revenue Code of 1954.]

stitutes an unconstitutional burden upon an essential governmental activity of Georgia. At first the respondent collected the tax as required by the Act, paid it over to the Treasury, and made claim for refund. The claim was rejected on the ground that the tax was paid by the patron of the game, and that the athletic associations and the respondent were mere collecting agents having no interest in the fund which would justify repayment to them if it had been illegally collected. Believing the basis of the Commissioner's refusal to refund was sound, the respondent then resorted to the expedient of collecting the amount of the tax under the reservation printed upon the tickets.

The bill, after reciting the facts as above summarized, alleges that the statute imposes a tax upon the individuals who purchase tickets, but, properly construed, is inapplicable to those purchasing tickets to the football games in question. It further asserts that, in respect of those games, neither the respondent nor the athletic associations collected any tax from purchasers of admissions; that if the statute be construed to justify the Collector in seeking to force respondent to pay sums representing alleged taxes due from numerous individuals it is unconstitutional as an attempt to interfere with and control and to burden the State's educational activities and unlawfully to impose on the State government the duty of collecting taxes for the federal government; that the action of the petitioner in issuing warrants of distraint is either an attempt to collect from respondent taxes alleged to be due from various individuals, or to impose upon the respondent penalties, criminal and punitive in nature.

The dispute as to the propriety of a suit in equity must be resolved in the light of the nature of the controversy. The respondent in good faith believes that an unconstitutional burden is laid directly upon its transactions in the sale of licenses to witness athletic exhibitions conducted under authority of the State and for an essential governmental purpose. The State is entitled to have a determination of the question whether such burden is imposed by the statute as construed and applied. It is not bound to subject its public officers and their subordinates to pains and penalties criminal and civil in order to have this question settled, if no part of the sum collected was a tax, and if the assessment was in truth the imposition of a penalty for failure to exact a tax on behalf of the United States. And if the respondent is right that the statute is invalid as applied to its exhibitions, it ought not to have to incur the expense and burden of collection, return, and prosecution of claim for refund of a tax upon others which the State may not lawfully be required to collect. These extraordinary circumstances we think justify resort to equity.

What we have said indicates that R.S. 3224, supra, does not oust the jurisdiction. The statute is inapplicable in exceptional cases where there is no plain, adequate, and complete remedy at law.[4] This is such a case, for here the assessment is not of a tax payable by respondent but of a penalty for failure to collect it from another. The argument that no remedy need be afforded the respondent is bottomed on the assumption that it is a mere collecting agent which cannot be hurt by collecting and paying over the tax; but this argument assumes first, that respondent did in truth collect a tax and, second, that the imposition of the tax on the purchase of admissions cannot burden a state activity. This is arguing in a circle, for these are the substantial matters in controversy. We hold that the bill states a case in equity as, upon the showing made, the respondent was unable by any other proceeding adequately to raise the issue of the unconstitutionality of the Government's effort to enforce payment.[5]

Reversed.

MR. JUSTICE CARDOZO took no part in the consideration or decision of this case.

MR. JUSTICE BLACK concurs in the result.

MR. JUSTICE REED concurs in the result.

Except for the holding that injunction is a proper remedy to test the position of the Regents, I agree with the opinion of the Court. As even a small breach in the general scheme of taxation gives an opening for the disorganization of the whole plan, it seems desirable to express dissent from the conclusion that the Regents may utilize the summary remedy of injunction, over the objection of the Government, as a means of testing the applicability of a tax law to them. . . .

The prompt collection of revenue is essential to good government. . . . Any departure from the principle of "pay first and litigate later" threatens an essential safeguard to the orderly functioning of government. Here an injunction is approved when the petitioner below had little more legitimate interest in the collection of the tax than a curiosity to know whether the customers of its athletic spectacles, the real taxpayers, were constitutionally subject to such an exaction.

I am authorized to say that MR. JUSTICE STONE concurs in this opinion. MR. JUSTICE BLACK concurs in this opinion except in so

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4 Miller v. Standard Nut Margarine Company, 284 U.S. 498, 509.

5 The balance of the opinion, holding that the conduct of the games was "not such a function of state government as to be free from the burden of a non-discriminatory tax," is omitted.

far as it approves the reasoning of the Court on the question of State immunity from interference by Federal taxation.

MR. JUSTICE STONE, concurring in the result.

Congress, by R.S. section 3224, has declared that "No suits for the purpose of restraining the assessment or collection of any tax shall be maintained in any court." While I agree with the decision of the Court on the merits, I am not persuaded that this statute does not mean what it says, or that the suit is not one to restrain collection of the tax. I can only conclude, as I did in *Miller v. Standard Nut Margarine Co.*, 284 U.S. 498, 511, that the statute deprived the district court of jurisdiction to entertain respondent's suit, and that the judgment should be reversed with direction that the cause be dismissed.

The dissenting opinion of MR. JUSTICE BUTLER (on the merits), in which MR. JUSTICE MCREYNOLDS concurred, is omitted.

Notes

The problem (now arising under sec. 7421(a) of the 1954 Code) is discussed in Lipton, "Enjoining Assessment or Collection of a Tax," N.Y.U. 18th Ann. Inst. on Fed. Tax. 957 (1960); Greener, "The Injunction in Federal Tax Cases," 21 Tenn.L.Rev. 237 (1950), also in 28 Taxes 959 (1950). See also "Enjoining the Assessment and Collection of Federal Taxes Despite Statutory Prohibition," 49 Harv.L.Rev. 109 (1935). Should Congress amend the statute by adding the words "and we mean it" at the end?

Recent cases in which "exceptional circumstances" were found, and an injunction granted, include *Smith v. Flinn,* 261 F.2d 781 (C.A.8th, 1958); *Yoke v. Mazzello,* 202 F.2d 508 (C.A.4th, 1953); *Shelton v. Gill,* 202 F.2d 503 (C.A.4th, 1953); *Yoshimura v. Alsup,* 167 F.2d 104 (C.C.A.9th, 1948). But *cf. Milliken v. Gill,* 211 F.2d 869 (C.A.4th, 1954); *Sturgeon v. Schuster,* 158 F.2d 811 (C.C.A.10th, 1947).

Note that the statute specifically provides that an injunction shall issue if the Commissioner attempts to assess a tax during a period when the law forbids him to do so. Sec. 6213(a) of the 1954 Code.

The Court has occasionally enjoined a corporation upon suit of a stockholder from paying a tax which the stockholder regards as invalid. This was the way in which *Pollock v. Farmer's Loan & Trust Co., supra,* p. 33, came up. For a more recent discussion, see *Helvering v. Davis,* 301 U.S. 619 (1937). Such a suit does not prevent the assessment or collection of a tax by the government, but it does prevent voluntary payment by the corporation. In view of the availability of refund procedures, what basis is there for invoking equity jurisdiction? Was there a more substantial basis for such a suit in the period before 1924, when a tax which was paid without protest or duress could not be recov-

ered? What weight should be given the determination of the court issuing the injunction in a subsequent deficiency proceeding?

Declaratory Judgments. By sec. 405 of the Revenue Act of 1935, the federal declaratory judgment provisions in sec. 274D of the Judicial Code were amended by adding the phrase "(except with respect to federal taxes)" to the clause granting declaratory judgment jurisdiction. This is now found in Title 28, U.S.Code, sec. 2201. The effect is to exclude federal tax questions from the declaratory judgment procedure. See *Angell v. Schram,* 109 F.2d 380 (C.C.A.6th, 1940), which denied declaratory relief, but apparently overlooked this amendment of the statute; *England v. United States,* 261 F.2d 455 (C.A.7th, 1958), relying on the statute.

Declaratory Rulings. A wholly different problem is presented with respect to declaratory rulings by the Internal Revenue Service. How far is it desirable or feasible for the Service to undertake to give binding rulings as to the tax consequences of contemplated transactions? The matter is discussed in detail in Oliphant, "Declaratory Rulings," 24 A.B.A.J. 7 (1938). See Rev.Proc. 59–22, below.

Closing Agreements. Under sec. 7121 of the 1954 Code, the Secretary or his delegate is given authority to enter into binding agreements with respect to past or future tax liability. These are known as closing agreements. By Treas. Dept. Order No. 150–2, published in 17 Fed. Register 4590 (1952), the Secretary delegated his authority with respect to closing agreements (and other matters) to the Commissioner. See Mim. 6772, 1952–1 Cum.Bull. 151.

Under the previous law stated in sec. 3760 of the 1939 Code, a closing agreement had to be approved by the Secretary, the Under Secretary, or an Assistant Secretary. On this basis closing agreements were hard to obtain, and required much time before approval. See Mim. 6383, 1949–2 Cum.Bull. 100.

Settlement of Suits. Under sec. 7122 of the 1954 Code the Secretary or his delegate has power to settle suits before they have been referred to the Department of Justice. After that time, the Attorney General or his delegate has such power.

REVENUE PROCEDURE 59–22

Internal Revenue Service, 1959. 1959–1 Cum.Bull. 834.

Section 1. *Purpose.*

The Internal Revenue Service calls attention to the necessity for strict compliance with its rules regarding requests for rulings on prospective transactions and extends these rules in the respects stated below.

Sec. 2. *Background.*

.01 The rules are contained in Revenue Ruling 54–172, C.B. 1954–1, 394. They have been in effect since 1954, but in some respects there have been increasing laxities in complying with them.

.02 Particular attention is called to two provisions of the Revenue Ruling. One of these requires that if a taxpayer is contending for a particular determination, he must submit an explanation of the ground for such contention, together with a memorandum of relevant authorities. Even though the taxpayer is urging no particular determination or determinations with respect to a prospective transaction, it is required that he state his views as to the tax results of the proposed transaction, accompanying them with a memorandum of relevant authorities.

.03 The other provision of the Revenue Ruling, to which attention is directed, requires the submission, with the application for a ruling, of a complete statement of all of the facts regarding the proposed transaction. These include, but are not necessarily limited to, identification of all of the parties concerned; a full and precise statement of the business reasons, if any, for the transaction; and conformed copies of all contracts, wills, deeds, agreements, trust indentures, or other documents involved in the transaction. When documents are filed, they are to be accompanied by an analysis of their bearing on the issue or issues in question, specifying the pertinent provisions.

Sec. 3. *Procedure.*

.01 While this Procedure is intended primarily to call the attention of practitioners to the extension of the requirements of Revenue Ruling 54–172, *supra,* it is to be observed that every application for a ruling must meet *all* of the requirements of the Revenue Ruling. This Procedure is not intended to relinquish any requirements stated in the Ruling.

.02 Any application hereafter filed for a ruling on a prospective transaction that does not comply with all of the provisions of Revenue Ruling 54–172, as extended by this Procedure, will be acknowledged by a form letter pointing out the requirements which have not been met and stating that the case has been closed, subject to reopening if, and when, the application is completed in conformity with the requirements. The same procedure will be followed with respect to applications on hand which ask for particular determinations but do not comply with the Revenue Ruling. Similar action may also be taken if the memorandum of authorities or the statement of facts, or both, submitted in response to such a form letter, are insufficient. For example, a memorandum of authorities is insufficient when it does not deal ade-

quately with each issue involved; and a statement of facts is insufficient when it does not include all the facts bearing upon the tax results of the transaction or when it is not accompanied by copies of all of the pertinent documents, or when a document is not accompanied by an analysis of its bearing on the issue or issues, specifying the pertinent provisions.

.03 In connection with its consideration of an application for a ruling in the situations covered by these rules, the Revenue Service may, at any stage of the case, require the submission of an appropriate memorandum of relevant authorities, or such other additional statement as may be essential to a determination of the issue.

Sec. 4. *Effect on Other Documents.*

Revenue Ruling 54–172, C.B.1954–1, 394, is extended.

Notes

See also Rev.Proc. 60–6, 1960–1 Cum.Bull. ——, giving an extensive list of "areas in which rulings will not be issued."

See Rose, "The Rulings Program of the Internal Revenue Service," 35 Taxes 907 (1957); Tannenbaum, "How to Obtain Treasury Department Rulings," 33 Taxes 346 (1955).

Administrative and Procedural rules before the Internal Revenue Service are now covered fully by Title 26, Part 601 of the Code of Federal Regulations. This is printed in full in 1955–2 Cum.Bull. 921–996.

B. REFUNDS

INTERNAL REVENUE CODE OF 1954

Sec. 7422. *Civil Action for Refund.*

(a) No Suit Prior to Filing Claim for Refund.—No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary or his delegate, according to the provisions of law in that regard, and the regulations of the Secretary or his delegate established in pursuance thereof.

(b) Protest or Duress.—Such suit or proceeding may be maintained whether or not such tax, penalty, or sum has been paid under protest or duress.[1]

[1] Paragraphs (c), (d), and (e) are omitted.

Sec. 6532. *Periods of Limitation on Suits.*

(a) Suits by Taxpayers for Refund.—

(1) General rule.—No suit or proceeding under section 7422 (a) for the recovery of any internal revenue tax, penalty, or other sum, shall be begun before the expiration of 6 months from the date of filing the claim required under such section unless the Secretary or his delegate renders a decision thereon within that time, nor after the expiration of 2 years from the date of mailing by registered mail by the Secretary or his delegate to the taxpayer of a notice of the disallowance of the part of the claim to which the suit or proceeding relates.

(2) Extension of time.—The 2-year period prescribed in paragraph (1) shall be extended for such period as may be agreed upon in writing between the taxpayer and the Secretary or his delegate.

(3) Waiver of notice of disallowance.—If any person files a written waiver of the requirement that he be mailed a notice of disallowance, the 2-year period prescribed in paragraph (1) shall begin on the date such waiver is filed.

(4) Reconsideration after mailing of notice.—Any consideration, reconsideration, or action by the Secretary or his delegate with respect to such claim following the mailing of a notice by registered mail of disallowance shall not operate to extend the period within which suit may be begun.

(b) Suits by United States for Recovery of Erroneous Refunds. —[omitted].

Note

See Brodsky, "Suits For Refund: The Nature of the Suit and the Procedure to be Followed," 11 N.Y.U.Ann.Tax.Inst. 749 (1953); Emmanuel, "Federal Tax Refund Procedure," 5 Fla.L. Rev. 133 (1952); Goldring, "Claims for Refund," 30 Taxes 194 (1952).

UNITED STATES v. FELT & TARRANT MANUFACTURING COMPANY

Supreme Court of the United States, 1931. 283 U.S. 269.

MR. JUSTICE STONE delivered the opinion of the Court.

This Court granted certiorari, 281 U.S. 719, to review a judgment of the Court of Claims, allowing recovery by respondent of income and excess profits taxes alleged to have been illegally exacted for the year 1917. 69 Cts.Cls. 204; 37 F.2d 977. It is conceded that respondent was entitled to a reduction from gross income for that year on account of exhaustion or obsolescence of patents, . . . which, if allowed, would result in the refund demanded.

The sole objection to recovery urged by the Government is that the claim for refund filed by petitioner as a prerequisite to suit did not comply with section 1318 of the Revenue Act of 1921, 42 Stat. 314, and Article 1036 of Treasury Regulations 62, under that Act.

Section 1318 provides that "no suit . . . shall be maintained in any court for the recovery of any internal-revenue tax alleged to have been . . . illegally . . . collected . . . until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury. . . ." Article 1036, Treasury Regulations 62, provides that claim for refund shall be made on Form 843 and that "all the facts relied upon in support of the claim should be clearly set forth under oath."

Respondent filed an application under oath for reduction of its 1917 tax liability and for a corresponding return of taxes paid, on Form 843, which it designated a claim "for refund of taxes illegally collected." But the sole ground stated for the demanded reduction of tax was that respondent had filed with the Commissioner an application for special relief from the amount of its excess profits tax under section 210 of the Act of 1917, 40 Stat. 307.

That section provides for a special method of assessment of excess profits taxes in any case where the Secretary of the Treasury is unable satisfactorily to determine the invested capital of the taxpayer. It has no relation to deductions from gross income on account of exhaustion or obsolescence of patents. In support of its claim, which was ultimately allowed in part, respondent prepared and filed a brief, and an oral argument was held in the office of the Commissioner; but neither in its claim for refund, its brief, nor at the hearing, was mention made of the deduction now claimed.

The filing of a claim or demand as a prerequisite to a suit to recover taxes paid is a familiar provision of the revenue laws, compliance with which may be insisted upon by the defendant, whether the collector or the United States. *Tucker v. Alexander,* 275 U.S. 228; *Maryland Casualty Co. v. United States,* 251 U.S. 342, 353, 354; *Kings County Savings Institution v. Blair,* 116 U.S. 200; *Nichols v. United States,* 7 Wall. 122, 130.

One object of such requirements is to advise the appropriate officials of the demands or claims intended to be asserted, so as to insure an orderly administration of the revenue, *Nichols v. United States, supra,* p. 130, a purpose not accomplished with respect to the present demand by the bare declaration in respondent's claim that it was filed "to protect all possible legal rights

of the taxpayer." The claim for refund, which section 1318 makes prerequisite to suit, obviously relates to the claim which may be asserted by the suit. Hence, quite apart from the provisions of the Regulation, the statute is not satisfied by the filing of a paper which gives no notice of the amount or nature of the claim for which the suit is brought, and refers to no facts upon which it may be found.

The Court of Claims, in allowing recovery, relied upon *Tucker v. Alexander, supra,* and upon the fact that, at the time when respondent filed its return and its claim for refund, the Treasury had consistently refused to allow deductions from gross income for exhaustion of patents. Consequently it held that the filing of a demand which was certain to be refused was a futile and unnecessary act. But in *Tucker v. Alexander* the right of the Government to insist upon compliance with the statutory requirement was emphasized. Only because that right was recognized was it necessary to decide whether it could be waived. The Court held that it could, and that in that case it had been waived by the stipulation of the collector filed in court. Here there was no compliance with the statute nor was there a waiver of its condition, since the Commissioner had no knowledge of the claim and took no action with respect to it.

The necessity for filing a claim such as the statute requires is not dispensed with because the claim may be rejected. It is the rejection which makes the suit necessary. An anticipated rejection of the claim, which the statute contemplates, is not a ground for suspending its operation. Even though formal, the condition upon which the consent to suit is given is defined by the words of the statute, and "they mark the conditions of the claimant's right." *Rock Island R. R. v. United States,* 254 U.S. 141, 143. Compliance may be dispensed with by waiver, as an administrative act, *Tucker v. Alexander, supra;* but it is not within the judicial province to read out of the statute the requirement of its words. *Rand v. United States,* 249 U.S. 503, 510.

Reversed.

Notes

(A) See also *Sicanoff Vegetable Oil Corp. v. United States,* 181 F.Supp. 265 (Ct.Cls.1960), where the taxpayer paid excess profits tax for 1951. In 1954, the government started a proceeding claiming that the company was a personal holding company and owed personal holding company tax. If it was a personal holding company, it was exempt from excess profits tax. The company defended against the claim for personal holding company tax, but filed a "protective" claim for refund of the excess profits tax, claiming that it was entitled to a refund if it was eventually held that it was a personal holding company. In 1958, the taxpayer won the personal holding company case, and it was held that it was not subject to that tax. In 1958, after the

time for filing claims for refund of the 1951 excess profits tax had expired, it filed an amended claim, based on the ground that the 1951 tax was overpaid, for various stated reasons. The court held that the 1958 claim was too late, and denied recovery.

(B) Under a provision which was new in the 1954 Code, any document other than a return is regarded as filed on time, under certain conditions, if it bears a United States postmark dated within the time, and if it is actually received thereafter. See sec. 7502(a) of the 1954 Code. But this does not apply to returns. Cf. *Doriss v. Commissioner,* 3 T.C. 219 (1944), involving the question whether a return was filed on time, when it was on the collector's hand truck in the post office when the time expired.

(C) As to the time when a suit or proceeding is begun within the provision limiting the time for starting suit after the rejection of a claim for refund, see Rule 3 of the Rules of Civil Procedure for the District Courts of the United States.

UNITED STATES v. ANDREWS

Supreme Court of the United States, 1938. 302 U.S. 517.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

In this case we are called upon to determine whether a claim for refund of income tax, asking repayment of a definite sum upon a specific ground, is susceptible of untimely amendment to recover a greater sum on a new and unrelated ground.

The respondent, on behalf of the estate she represented, paid the income tax shown to be due by her return, which exhibited an item of gross income of $110,891 as "dividends from domestic corporations." Of this total $36,750 was erroneously reported as dividends from the M. A. Hanna Company. This amount was paid her pursuant to a recapitalization of the company in which the estate owned preferred stock and, instead of being returned as a dividend, should have been treated as giving rise to a capital gain of $7,411.50.

In December 1931 the respondent was advised by an Internal Revenue agent that her return reporting the receipt as a dividend, was considered correct, subject to the approval of the Bureau in Washington, and that if later information should indicate a material change in the amount of tax the statutes would require a redetermination of tax liability. October 6, 1932, as the result of conferences with representatives of the Hanna Company, the Commissioner of Internal Revenue advised the Agent in Charge at Cleveland, Ohio, that the cash received by preferred stockholders in the recapitalization of the company represented proceeds from a sale and that gain or loss therefrom should be determined upon the basis of the cost of the original stock. The respondent was not notified of the ruling until August 22, 1934.

February 1, 1933, respondent filed a claim for the refund of $995.52, based upon an alleged loss in the taxable year due to the worthlessness of stocks of two corporations. Consideration and action thereon were delayed pending the outcome of litigation which would affect the soundness of the claim. In 1936 this claim was rejected in part but allowed to the extent of $160, which was refunded.

June 29, 1934, after expiration of the statutory period for filing refund claims,[1] the respondent presented a claim for $6,454.09 in which she stated that it was "filed as an amendment and amplification of claim for refund filed February 1, 1933" and asserted that the sum of $36,750 reported as a dividend was not such but represented the proceeds of sale of stock in the Hanna Company as a profit of $7,411.50 and that the error in the return resulted in an overpayment of $6,454.09.

November 2, 1935, the Commissioner advised the respondent that, while an overpayment had been made, a refund would be denied because the claim of June 1934 was wholly unrelated to that of February 1, 1933, being an independent demand based upon an entirely different ground. Pursuant to the Commissioner's holding that the latter claim was not filed within the period prescribed by law and, therefore, could not be allowed, official notice of rejection was mailed December 16, 1935. The respondent brought suit in the Court of Claims which gave judgment for her in the amount of $5,536.97.

Upon petitioner's representation that the decision is in conflict with decisions of this court and of two circuit courts of appeals we granted the writ of certiorari. We hold that the so-called amendment was in fact a new claim and its allowance was barred by the statutory provision limiting the time for presentation of claims for refund.

Notwithstanding the reliance of each of the parties on recent decisions of this court none of them rules the precise question now presented. They point the way, however, to a correct decision.[2]

In each of these cases the claim failed to comply with a Treasury Regulation requiring that the grounds for the relief demanded should be set forth under oath and in detail. We held that while the Commissioner might promptly have rejected the claims for failure to comply with the regulation such compliance was a matter he could waive and, if he considered the merits, the claim was susceptible of any amendment which would not amount, under the rules of pleading in actions at law, to an alteration of the

1 Revenue Act of 1928, Ch. 852, Sec. 322(b)(1), 45 Stat. 791, 861.

2 [The Court here set out the facts of United States v. Memphis Cotton Oil Co., 288 U.S. 62 (1933), and United States v. Factors & Finance Co., 288 U.S. 89 (1933).].

cause of action and would not require the Commissioner to make a new and different inquiry than that which he was called upon to make in order to consider the general grounds asserted in support of the claim as presented. . . .

In all these cases the court found the analogies of pleading helpful in deciding whether the claim was in such form as to be subject to the proffered amendment at a time when a claim wholly new would have been barred; but the opinions point out that the analogy to pleading at law is not to be so slavishly followed as to ignore the necessities and realities of administrative procedure. Where a claim which the Commissioner could have rejected as too general, and as omitting to specify the matters needing investigation, has not misled him but has been the basis of an investigation which disclosed facts necessary to his action in making a refund, an amendment which merely makes more definite the matters already within his knowledge, or which, in the course of his investigation, he would naturally have ascertained, is permissible. On the other hand, a claim which demands relief upon one asserted fact situation, and asks an investigation of the elements appropriate to the requested relief, cannot be amended to discard that basis and invoke action requiring examination of other matters not germane to the first claim.

With these settled principles in mind we turn to the circumstances disclosed in the present case. The claim here was not general but specific. It did not assert generally that income, gross or net, had been overappraised, or, generally, that the taxayer was entitled to deductions not taken or granted. On the contrary, it pointed to two specific items of deduction which had not been taken and to which the taxpayer claimed to be entitled. It stated that during the taxable year the taxpayer's holdings of stock in two named corporations had become worthless, entailing a deductible loss of $995. While the claim added the phrase that the taxpayer claimed the sum named, or any greater sum which might be ascertained to be due, this did not call upon the Commissioner to make a complete reaudit of the taxpayer's return. The fact that he might have done so is immaterial. . . . While matters were in this posture, and after the period of limitation had expired, the respondent presented a so-called amendment of her claim having no relation whatever to the items set forth in the original claim but dealing with a wholly distinct item of $36,750 reported as dividends received and asking that it be eliminated from that category and that the transaction be reclassified as capital gain upon a basis which would result in a reduction of tax by some $6,000. This is not a case where the Commissioner waived the regulation with respect to the particularity with which the grounds of the claim must be set forth.

There was no need for him to do so. The claim was not general like that in the *Memphis Cotton Oil* case and the others following in its train. It was as specific as it could be made and pointed unerringly to the items the Commissioner must consider. It called for no general audit of the taxpayer's affairs and apparently none was made. An investigation of the items designated could not have the least relation to that attempted to be opened in the untimely amendment. The respondent urges that these considerations are of no legal significance, since the claim not only called for redress of a specified grievance but demanded general relief as well. She insists we have likened a claim for refund to an action for money had and received and have required the Commissioner to accept and act upon a bill of particulars furnished him before actual rejection of the claim although the period of limitation has expired. But, as we said in *United States v. Henry Prentiss & Co., Inc.,* [288 U.S. 73], p. 84, "This does not mean that a pleader who abandons the common count and states the particular facts out of which his grievance has arisen retains unfettered freedom to change the statement at his pleasure." . . .

The judgment is

Reversed.[3]

Notes

(A) In *United States v. Kales,* 314 U.S. 186 (1941), statements made in a protest filed by the taxpayer were held to amount to an informal claim for refund which could be perfected and amended by a formal claim which was filed after the limitations period had expired.

(B) A claim for the refund of income tax for the year 1933 was filed on time and rejected on August 13, 1935. On February 4, 1937, a second claim was filed based on the same ground. This was rejected on August 4, 1937. Suit was filed on January 10, 1939. May the suit be maintained? *Einson-Freeman Co. v. Corwin,* 112 F.2d 683 (C.C.A.2d, 1940), cert. den. 311 U.S. 693 (1940).

(C) In *Flora v. United States,* 357 U.S. 63 (1958), the Court held that a suit for a refund could not be maintained unless all the tax claimed by the Government had been paid. This result was confirmed on rehearing in *Flora v. United States,* 362 U.S. 145 (1960), a five to four decision. This seems to present some difficulties to the taxpayer who pays all he has, though not all he owes, and who is unable to go to the Tax Court either because he has let that opportunity pass or because he never had a chance to go to the Tax Court, as in the case of the numerous excise taxes, like admissions, manufacturers' excise tax, and so on.

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3 See Sherman, "The Grounds, Facts, and Evidence in Tax Refund Claims," 25 Taxes 985 (1947).

When the time comes to start a suit, the taxpayer has three procedural alternatives—an option which cannot be explained in terms of a rational tax system, but only as historical survivals. The alternatives are: (1) a suit in the United States District Court under Title 28, U.S.Code, sec. 1340, against the district director who collected the tax; (2) a suit against the United States in the Court of Claims [4] under sec. 1491 of Title 28; and (3) a suit against the United States in the District Court under sec. 1346 of Title 28.[5] The last alternative has recently been extended (by the Act of July 30, 1954, c. 648, 83rd Congress) to all tax suits and is no longer limited. Under the law previously in effect such suits against the United States could be brought only on claims not exceeding $10,000, unless the district director who collected the tax was dead or out of office, in which cases the suit against the United States in the District Court might be for any amount. Previously, jury trials could be had only in suits against district directors, that is, alternative (1), above. But the same Act of July 30, 1954, now extends the right of jury trial to suits against the United States in the District Courts, under alternative (3) above.

In the past jury trials were extremely rare in civil tax cases.[6] In recent years, they have been increasing rapidly. In the fiscal years 1952 through 1958, there were 380 jury trials (very few requested by the government) out of a total of 2924 civil tax trials, or a proportion of 13%. In the fiscal year 1959, there were 174 jury trials out of a total of 773 civil tax trials, or a proportion of 23%. For general consideration of the question, see Holzman, "Should You Use a Jury?" 36 Taxes 301 (1958); "Is the Taxpayer Neglecting the Jury?" 28 Cin.L.Rev. 352 (1959).

SMIETANKA v. INDIANA STEEL COMPANY

Supreme Court of the United States, 1921. 257 U.S. 1.

MR. JUSTICE HOLMES delivered the opinion of the Court.

This is a suit brought to recover internal revenue special taxes for the years 1910 and 1912, asssessed under the Act of Congress of August 5, 1909, c. 6, sec. 38, 36 Stat. 11, 112; and paid by the

[4] See Pavenstedt, "The United States Court of Claims as a Forum for Tax Cases," 15 Tax L.Rev. 1 (1959), 15 Tax L.Rev. 201 (1960).

[5] See Dorkery, "Refund Suits in District Courts," 31 Taxes 523 (1953); Thomson, "Tax Jurisdiction of the District Courts," 29 Taxes 57 (1951).

[6] "In 1936 there were only four jury trials and in 1937 only two, both requested by the government." Traynor, "Administrative and Judicial Procedure for Federal Income, Estate, and Gift Taxes," 38 Col.L.Rev. 1393, 1426 (1938). In 1938, the number was five, and four in 1939. See Surrey, "Some Suggested Topics in the Field of Tax Administration," 25 Wash.U.L.Q. 399, 418 (1940).

plaintiff, the defendant in error, under duress. The taxes were collected by S. M. Fitch, then collector of internal revenue, and it was certified by the District Court as part of its judgment that there was probable cause for the act of the collector, that he acted under the direction of the Commissioner of Internal Revenue, and that the amounts recovered should be provided for and paid out of the proper appropriation from the Treasury of the United States. The defendant is the present collector for what was Fitch's district and was held liable by this judgment. The case was taken to the Circuit Court of Appeals which has certified the following questions:

"1. Assuming that the declaration states a good cause of action had the suit been brought against S. M. Fitch, the internal revenue collector who actually collected and received the taxes, does it state any cause of action whatever against said S. M. Fitch's successor in office, the plaintiff in error, against whom the suit was brought, but who had no participation in the collection, receipt or disbursement of such taxes?

"2. May suit in the District Court of the United States properly be brought and maintained against a United States collector of internal revenue for the recovery of the amount of a United States internal revenue tax, unlawfully assessed and collected, but in the collection and disbursement of which such collector had no agency, the entire transaction of such assessment, collection and disbursement having occurred during the incumbency of such office of a predecessor in office of such collector?"

As the law stood before later statutes a collector was liable personally for duties mistakenly collected, if the person charged gave notice, at the time, of his intention to sue, and warning not to pay over the amount to the Treasury. *Elliott v. Swartwout,* 10 Pet. 137. But, after an act of Congress had required collectors to pay over such monies, it was held, against the dissent of Mr. Justice Story, that the personal liability was gone. *Cary v. Curtis,* 3 How. 236. Later statutes however recognize suits against collectors in such cases, and the plaintiff contends that they should be construed to create a new statutory liability attached to the office and passing to successors, as was held in this case, the formal defendant being saved from harm by the United States. This however is not the language of the statutes and hardly can be reconciled with the decision of this Court in *Sage v. United States,* 250 U.S. 33, and other cases to which we shall refer.

To show that the action still is personal, as laid down in *Sage v. United States,* 250 U.S. 33, 37, it would seem to be enough to observe that when the suit is begun it cannot be known with certainty that the judgment will be paid out of the Treasury.

That depends upon the certificate of the Court in the case. It is not to be supposed that a stranger to an unwarranted transaction is made answerable for it; yet that might be the result of the suit if it could be brought against a successor to the collectorship. A personal execution is denied only when the certificate is given. It is true that in this instance the certificate has been made, but the intended scope of the action must be judged by its possibilities under the statutes that deal with it. The language of the most material enactment, Rev.Stats., sec. 989, gives no countenance to the plaintiff's argument. It enacts that no execution shall issue against the collector but that the amount of the judgment shall "be provided for and paid out of the proper appropriation from the "Treasury," when and only when the Court certifies to either of the facts certified here, and "when a recovery is had in any suit or proceeding against a collector or other officer of the revenue for any act done by him, or for the recovery of any money exacted by or paid to him and by him paid into the Treasury, in the performance of his official duty." A recovery for acts done by the defendant is the only one contemplated by the words "by him." The same is true of Rev.Stats., sec. 771, requiring District Attorneys to defend such suits.

No different conclusion results from the Act of February 8, 1899, c. 121, 30 Stat. 822. That is a general provision that a suit by or against an "officer of the United States in his official capacity" should not abate by reason of his death, or the expiration of his term of office, &c., but that the Court upon motion within twelve months showing the necessity for the survival of the suit to obtain a settlement of the question involved, may allow the same to be maintained by or against his successor in office. Whether this would apply to a suit of the present kind is at least doubtful. *Roberts v. Lowe,* 236 Fed. 604, 605. In *Patton v. Brady,* 184 U.S. 608, a suit against a collector begun after the passage of this statute, it was held that it could be revived against his executrix, which shows again that the action is personal; as also does the fact that the collector may be held liable for interest. *Erskine v. Van Arsdale,* 15 Wall. 75. *Redfield v. Bartels,* 139 U.S. 694. But in any event the statute supposes a suit already begun against the officer in his lifetime. We need not consider the remedies against the United States. *United States v. Emery, Bird, Thayer Realty Co.,* 237 U.S. 28; *Sage v. United States,* 250 U.S. 33. It appears to us plain without further discussion that both questions must be answered: No.

Answers to Questions 1 and 2: No.

MR. JUSTICE MCKENNA and MR. JUSTICE CLARKE dissent.

Notes

The right to sue the district director (formerly, the collector) personally has been referred to by the Supreme Court as "an anomalous relic of bygone modes of thought." *George Moore Ice Cream Co. v. Rose,* 289 U.S. 373, 382 (1933). For a full discussion, see Plumb, "Tax Refund Suits against Collectors of Internal Revenue," 60 Harv.L.Rev. 685 (1947). See also Brown, "Refund Suits against Collectors," 28 Taxes 937 (1950); Dockery, "Refund Suits in District Courts," 31 Taxes 523 (1953).

Credits. Even if the government officers determine that the taxpayer has overpaid his tax, there may be no refund. Instead the overpayment may be credited against any other income taxes which may then be due from the taxpayer. See sec. 6402 of the 1954 Code. This leads to various difficulties where the taxpayer contends that the tax paid by the credit was not due or was barred by the statute of limitations. See sec. 6514(b) of the 1954 Code. Suppose that the taxpayer has overpaid 1953 taxes and that the government has credited this against an alleged deficiency for 1952. If the taxpayer believes there was no deficiency for 1952, should he bring suit to recover an overpayment for 1953, or for 1952? See *United States v. Bertlesen & Petersen Engineering Co.,* 306 U.S. 276 (1939).

Account Stated. Where the government determines an overpayment, but refuses to make a refund on the ground either that the refund is barred by the statute of limitations, or that the overpayment should be credited, there has been some talk in the cases of the government's determination being an "account stated" which furnishes the basis for a suit on contract principles. *Bonwit Teller & Co. v. United States,* 283 U.S. 258 (1931); *R. H. Stearns Co. v. United States,* 291 U.S. 54 (1934); *Goodenough v. United States,* 85 Ct.Cl. 258, 19 F.Supp. 254 (1937). See "Account Stated as a Theory of Action for Recovering Federal Tax Overpayments," 56 Harv.L.Rev. 115 (1942). But see *United States v. A. S. Kreider Co.,* 313 U.S. 443 (1941).

LEWIS v. REYNOLDS

Supreme Court of United States, 1932. 284 U.S. 281.

MR. JUSTICE MCREYNOLDS delivered the opinion of the Court.

Petitioners sued the respondent Collector in the United States District Court for Wyoming, September 20, 1929, to recover $7,297.16 alleged to have been wrongfully exacted as income tax upon the estate of Cooper.

February 18, 1921, the administrator filed a return for the period January 1 to December 12, 1920, the day of final settlement. Among others, he reported deductions for attorney's fees, $20,750, and inheritance taxes paid to the State, $16,870. The amount of tax as indicated by the return was paid.

November 24, 1925, the Commissioner, having audited the return, disallowed all deductions except the one for attorney's fees

and assessed a deficiency of $7,297.16. This sum was paid March 21, 1926; and on July 27, 1926, petitioners asked that it be refunded.

A letter from the Commissioner to petitioners, dated May 18, 1929, and introduced in evidence by them, stated that the deduction of $20,750 for attorney's fees had been improperly allowed. He also set out a revised computation wherein he deducted the state inheritance taxes. This showed liability greater than the total sums theretofore exacted. The Commissioner further said: "Since the correct computation results in an additional tax as indicated above which is barred from assessment by the statute of limitations your claim will be rejected on the next schedule to be approved by the commissioner."

The trial court upheld the Commissioner's action and its judgment was affirmed by the Circuit Court of Appeals.

Counsel for petitioners relies upon the five-year statute of limitations (Revenue Act 1926, sec. 277).[1] He maintains that the Commissioner lacked authority to redetermine and reassess the tax after the statute had run; also that at the time of his last decision he was restricted to consideration of the demand for refund and determination of whether the trustees were entitled to deduct the State inheritance taxes.

After referring to section 284, Revenue Act of 1926, 44 Stat. 66 and section 322, Revenue Act of 1928, 45 Stat. 861, the Circuit Court of Appeals said: "The above quoted provisions clearly limit refunds to overpayments. It follows that the ultimate question presented for decision, upon a claim for refund, is whether the taxpayer has overpaid his tax. This involves a redetermination of the entire tax liability. While no new assessment can be made, after the bar of the statute has fallen, the taxpayer, nevertheless, is not entitled to a refund unless he has overpaid his tax. The action to recover on a claim for refund is in the nature of an action for money had and received and it is incumbent upon the claimant to show that the United States has money which belongs to him."

We agree with the conclusion reached by the courts below.

While the statutes authorizing refunds do not specifically empower the Commissioner to reaudit a return whenever repayment is claimed, authority therefor is necessarily implied. An overpayment must appear before refund is authorized. Although the statute of limitations may have barred the assessment and

[1] "Sec. 277. (a) Except as provided in section 278 [not here important]— . . . (3) The amount of income, excess-profits, and war-profits taxes imposed by . . . the Revenue Act of 1918, and by any such Act as amended, shall be assessed within five years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period."

collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded.

Bonwit Teller & Co. v. United States, 283 U.S. 258, says nothing in conflict with the view which we now approve.

Affirmed.

Notes

Cf. Routzahn v. Brown, 95 F.2d 766 (C.C.A.6th, 1938): the taxpayer brought suit to recover a tax on the ground that a certain gift was not in contemplation of death as the Commissioner had ruled. The case went to the Circuit Court of Appeals which ruled that the transfer was not taxable as a gift in contemplation of death, and remanded the case for a new trial. See *Brown v. Routzahn, infra,* p. 829 (D). At the second trial, the Government sought to amend its answer to show that there had in fact been no overpayment of tax because the decedent had made other transfers which had not been taxed. This was refused, the court saying (p. 771): "Assuming that upon retrial the collector has asserted but one of his new defenses, that judgment had followed, reversed upon appeal with mandate for new trial, that upon the third trial the collector had again amended, added another distinct defense, and so on ad infinitum, the taxpayer might thus be prevented from ever recovering an overpayment. This cannot be the law."

Interest. Under Sec. 6611(a) of the 1954 Code, interest is allowed on overpayments of tax, at the rate of 6% per annum. See Roberts and Harnett, "The Treatment of Interest on Over-assessments," 30 Taxes 795 (1952). Subsequent paragraphs of Sec. 6611 define the period for which interest is allowable, and state several exceptions to the rule allowing interest. Suppose an intentional overpayment is made, or a payment is made against a possible tax liability which does not in fact materialize. May interest be recovered on such an overpayment? See Alexander, "Overpayments of Taxes or Government Investments at Six Percent," 7 Tax L.Rev. 231 (1952).

In the case of deficiencies in tax, where the taxpayer has to pay the government, interest is also collected at the rate of 6%. See sec. 6601(a), and other provisions of the 1954 Code.

C. DEFICIENCIES

Until 1924, there was no method for determining questions of tax liability without first having to pay the tax. In that year, Congress responded to demands for an independent hearing in advance of payment by establishing the Board of Tax Appeals as "an independent agency in the Executive Branch of the Government." In 1942 the Board's name was changed to the Tax Court of the United States. For the present statutory provisions see section 7441 of the Internal Revenue Code of 1954. The Tax Court is presently composed of sixteen judges appointed by the

President with the advice and consent of the Senate for terms of twelve years. The Court's headquarters are in Washington, but regular hearings are held in the principal cities throughout the country. About ninety per cent of all litigated tax matters are tried before the Tax Court. It has become the most influential tribunal in the tax field. See Haden, "The Tax Court's Influence on Tax Law," 35 Va.L.Rev. 700, 862 (1949).

The Tax Court has jurisdiction *only in cases of deficiencies of income, estate, gift, and excess profits taxes.* In all other cases (such as excise taxes), the taxpayer who has lost before the Treasury has no choice but to pay the tax, file a claim for refund, and then sue to get it back if he so desires. The formal "determination of a deficiency," which is the prerequisite for Tax Court jurisdiction,[1] usually is the result of a series of dealings between the taxpayer and the local revenue officers.

First a revenue agent examines the return. He makes a report to his group chief. If the taxpayer does not accept the agent's report, he has an opportunity for a conference with the group chief.[2] If this does not produce agreement, the group chief notifies the taxpayer, informing him that he may either file a protest with the Internal Revenue Service, or, if he wishes to stop the running of interest, file a waiver consenting to the assessment of the tax which will preclude him from appealing to the Tax Court. The letter sent to the taxpayer is referred to as a thirty-day letter, because it customarily allows thirty days within which to file the protest.[3] If the taxpayer files a protest, he may obtain a hearing before the Appellate Division in the Regional Commissioner's Office. It is at these points that settlements are frequently reached.[4] See Statement of Procedural Rules, in 1955–2 Cum.Bull. 921.

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1 There are a few instances where the Tax Court has jurisdiction following the denial of a claim for refund. See *e. g.*, sec. 732 of the Code of 1939, relating to rejection of claims for relief from excess profits tax. *Cf.* sec. 6861 of the 1954 Code, relating to jeopardy assessments. But the Tax Court does not have general jurisdiction to review the denial of claims for refund. There seems to be no reason why such jurisdiction should not be extended to it.

In addition to its normal functions the Tax Court has occasionally been assigned jurisdiction over other matters, such as jurisdiction to review the renegotiation of government war contracts.

2 See Erbacher, "Federal Income Tax Problems of the Small Business," 32 Taxes 665, 671 (1954).

3 Mim. 3965, XI–2 Cum.Bull. 37 (1932), sets out the procedure for examination of income tax returns. This includes the requirements as to "Items which a protest must cover."

4 Decisions made in the district director's office are subject to review in Washington and are sometimes upset there. Decisions made by the Appellate Division are, however, for practical purposes binding on both parties. But they are not technically final, since they are not closing agreements; and though it is a clear breach of faith, settlements made with field offices may be disregarded by either party. See Joyce v. Gentsch, 141 F.2d 891 (C.C.A. 6th, 1944); Bank of New York v. United States, 170 F.2d 20 (C.A.3d, 1948);

If these negotiations do not produce a meeting of the minds, and the Service still believes that there is a deficiency in tax, a "deficiency letter" is sent by registered mail to the taxpayer's last known address. See sec. 6212(a) of the 1954 Code. This is the basis for the appeal to the Tax Court. Sec. 6213(a) of the 1954 Code. The deficiency letter is often referred to as a ninety-day letter, since the taxpayer may file a petition with the Tax Court within that period. The government may not assess the tax in the absence of a waiver until it has sent such a letter, and the ninety-day period has expired; [5] and if the taxpayer files a petition with the Tax Court, the government may not make the assessment until the Tax Court's decision becomes final, and then only in accordance with that decision. See section 6213(a) of the 1954 Code. Exception is made for jeopardy assessments. See p. 99, *infra.* Following a Tax Court decision on the merits, which becomes final (see sec. 7481 of the 1954 Code), the matter is closed. The government may assess and collect the tax and the taxpayer may not obtain any refund either of the amount so collected or of any other alleged overpayment in the tax for the year involved.[6]

If the taxpayer fails to appeal to the Tax Court within ninety days, or if he voluntarily pays the tax, he loses his chance to go to the Tax Court. The refund procedure, however, is still open to him; he may file a claim for refund, and then bring suit to recover the alleged overpayment. The choice may be influenced by the following factors, among others.

(1) The only way he can get a jury trial is by paying the tax, and suing the district director or the United States in the District Court. This is not usually an important element in the choice, except possibly in a contemplation of death case or a family partnership case. See *Farmers' Loan & Trust Co. v. Bowers, infra,* p. 823.

Ohl, "Implications of Form 870 and Related Tax 'Settlements'," 11 U. of Pittsburgh L.Rev. 173 (1950); "Finality of Administrative Settlements in Tax Cases," 57 Harv.L.Rev. 912 (1944); Gutkin, "Informal Federal Tax Settlements and Their Binding Effect," 4 Tax L.Rev. 477 (1949).

Where an adjustment made by a field office is disapproved on review in Washington, the taxpayer is entitled to a hearing before a representative of the Washington office, and this hearing will be held in the field. See Mim. 6125, 1947–1 Cum.Bull. 40. See also Mim. 6293, 1948–2 Cum.Bull. 58, giving taxpayers a hearing in Washington when a field office refers an issue to Washington for technical advice.

[5] The deficiency-letter procedures are required also in the assessment of penalties for failure to file timely returns, despite the contrary provision in Regulation Section 301.6659–1. Granquist v. Hackleman, 264 F.2d 9 (C.A.9th, 1959).

[6] This is true even where the decision of the Tax Court is for want of prosecution by the taxpayer. See Section 6512(a) of the 1954 Code, and Fiorentino v. United States, 226 F.2d 619 (C.A.3d, 1955).

(2) There may be some choice of courts. The course of Tax Court decisions may be against the taxpayer, while the Court of Claims has a decision squarely in his favor; or there may be a feeling that the case is one which will find a more sympathetic hearing from the local District Judge than from the remote Tax Court or Court of Claims.

(3) Another factor is that of interest. Any deficiency finally determined by the Tax Court will have to be paid with interest at six per cent (see, e. g., sec. 6601 of the 1954 Code), while if the tax is first paid and ultimately recovered through suit or otherwise the taxpayer is entitled to interest at six per cent. Sec. 6611 of the 1954 Code. These rates are fairly high. While they last, though, many taxpayers find there is no better way to get a government investment at six per cent.

In connection with procedure on deficiencies, see the following references: Spencer, "Income Tax Controversies with the Internal Revenue Agent in Charge," 64 Harv.L.Rev. 547 (1951); Propp, "Incorrectly Addressed 90-day Letters," 7 Tax L.Rev. 250 (1952); Stowe, "Audit, Informal Conference and Appellate Procedures in the Reorganized Bureau," 94 J. of Accountancy 299 (1951); Ohl, "Implications of Form 870 and Related Tax 'Settlements,' " 11 U. of Pitt.L.Rev. 173 (1950); Seghers, "How to Prepare Protests and Claims for Refund," 28 Taxes 254 (1950).

Cases before the Tax Court are tried on behalf of the Government by attorneys attached to the Appellate Division who are under the direction of the Chief Counsel for the Internal Revenue Service. In all other cases in court, including trials in the district courts and the Court of Claims, and appeals in the courts of appeals and the Supreme Court, the Government is represented by attorneys in the Department of Justice. Thus there is a complete change in the control of a case when it passes from the Treasury to a District Court or from the Tax Court to a court of appeals.

Attorneys or agents must be admitted to practice in the Treasury Department before they can represent taxpayers before any officer or office of the Treasury. The requirements for admission to practice are set out in Treasury Department Circular No. 230, revised in 1958. See 1959–1 Cum.Bull. 745. See also Rev.Proc. 59–3, 1959–1 Cum.Bull. 801. Applications must be filed with the Committee on Enrollment and Disbarment. In general, admission to the bar of some state is the chief requirement for admission

as an attorney. Department Circular No. 230 (revised) also contains a number of "Rules and regulations relating to practice," stating in considerable detail what an enrolled attorney may or may not do. Under sec. 10.37(a) an "attorney or agent shall not charge a manifestly unreasonable fee." Under sec. 10.37(b) an "attorney or agent shall not enter into a wholly contingent fee arrangement with a client for representation in any matter before the Internal Revenue Service unless the client is financially unable to pay a reasonable fee on any other terms."

In *Muldoon v. West End Chevrolet, Inc.,* 338 Mass. 91, 153 N.E. 2d 887 (1958), it was held that an agreement to pay "fair, adequate and just compensation for the services rendered" was not an agreement for a contingent fee.

The Treasury also has a code of Conference and Practice Requirements, now found in sub-part E of Part 601 of Title 26 of the Code of Federal Regulations. This is printed in 1955–2 Cum.Bull. 921, 984–992. Among other things, "No attorney or agent shall appear on behalf of any person before any office of the Internal Revenue Service or be recognized . . . unless such attorney . . . presents and files a power of attorney in proper form . . . from such person authorizing the attorney or agent to represent him in the matter in question." Specific provisions are made as to the form and contents of powers of attorney. Enrollment and power of attorney requirements must be met when recognition is desired through correspondence, even though no actual appearance is made before the Department.

Attorneys wishing to practice before the Tax Court must make application and be admitted by the Court. See Rule 2 of the Rules of the Tax Court.

Note

See, generally, Berman and Berman, "Practice and Procedure in the Tax Court: Some Suggestions on Tax Court Trial Work," 26 Temple L.Q. 275, 31 Taxes 535 (1953); Albro, "Procedure and Trial before the Tax Court," 25 Taxes 337 (1947); Procedure and Practice Before the Tax Court of the United States (C.C.H.; 18th ed. 1958). See also Paul, "A Plea for Better Tax Pleading: A Critique of Pleading in Tax Controversies Before the Board of Tax Appeals," 18 Corn.L.Q. 507 (1933).

Lawyers and Accountants

Tax counseling often calls for the skills of both the lawyer and the accountant. The difficult problem has been in determining the proper sphere for each profession. No clear or mutually

acceptable answer has as yet appeared.[1] See Austin, "Relations between Lawyers and Certified Public Accountants in Income Tax Practice," 36 Iowa L.Rev. 227 (1951); Lorinczi, "What Constitutes the 'Practice of Law' in Tax Matters," 35 Marq.L.Rev. 370 (1952); Carey, "Ethics, 'Unauthorized Practice,' and Federal Income Taxation—An Accountant's Viewpoint," 25 Rocky Mountain L.Rev. 435 (1953); Rembar, "The Practice of Taxes," 54 Col.L.Rev. 338 (1954), 97 J. of Accountancy 549 (1954); Richardson, "The Accountant's Position in the Field of Taxation," 98 J. of Accountancy 166 (1954).[2]

In 1951, a joint committee of accountants and lawyers issued a "Statement of Principles Promulgated by the National Conference of Lawyers and Certified Public Accountants," printed in 91 J. of Accountancy 869 (1951), and in 18 J. of D.C. Bar Ass'n 211 (1951).[3] Although this is stated in general terms, it has provided a basis on which many of the problems can be resolved. (Note that by no means all accountants are certified public accountants. Those who are not certified are subject to little if any professional control.)

See also Joint Statement Relating to practice in the Field of Taxation, promulgated by the New York State Bar Association and the New York State Society of Certified Public Accountants, 107 J. of Accountancy 75 (March, 1959), and in 82 N.Y.S. Bar Ass'n Rep. 168 (1959).

An effort to discuss some of the factors bearing on this problem is found in Griswold, "Lawyers and Accountants, and Taxes," 10 Record of the Ass'n of the Bar of the City of N. Y. 52 (1955), 2 J. of Taxation 130 (1955), 18 Texas State Bar Journal 109 (1955), 99 J. of Accountancy 33 (1955). See also Cohen, "The Growing Conflict: Are Accountants Practicing Law?" 29 Conn. B.J. 20 (1955); Griswold, "A Further Look at Lawyers and Accountants," 41 A.B.A.J. 1113 (1955), 100 J. of Accountancy 29 (1955); Griswold, "Role of Lawyer in Tax Practice," in U. of So. Calif. Tenth Tax Institute 1 (1958); Jameson, "A Proposed Code of Conduct: The Relationship of Lawyers and Accountants," 44 A.B.A.J. 1049 (1958). See also "The Plight of the Attorney-Certified Public Accountant—An Evaluation of a Proposed Code of

[1] Cases involving the question include Matter of New York County Lawyers' Ass'n v. Bercu, 273 App.Div. 524, 78 N.Y.S.2d 209 (1948), aff'd without opinion 299 N.Y. 728, 87 N.E.2d 451 (1949); Gardner v. Conway, 234 Minn. 468, 48 N.W.2d 788 (1951); Petition of Kearney, 63 So.2d 630 (Fla.1953); Rhode Island Bar Ass'n v. Libutti, 81 R.I. 182, 100 A.2d 406 (1953); Agran v. Shapiro, 127 Cal.App.2d Supp. 807, 273 P.2d 619 (1954). See also 9 A.L.R.2d 787 (1950), for earlier cases.

[2] See also Lourie and Cutler, "Lawyer's Engagement of Accountant in a Federal Tax Fraud Case," 10 Tax L.Rev. 227 (1955).

[3] There is a Comment on the Statement of Principles by Goedert in 26 Notre Dame Lawyer 168 (1951), followed by a reprint of the text of the Statement.

Conduct," 19 La.L.Rev. 830 (1959). The general question is the subject of a series of articles in the April, 1959, issue of the U. of Detroit L.J.

Limitations Against the Government

In the case of income and related taxes, the tax must be assessed in the ordinary case within three years after the return was filed. Sec. 6501(a) of the 1954 Code. Exceptions are provided in sec. 6501(c) in the case of false returns or where a waiver is filed. Note, too, that the period is six years if the taxpayer omits more than 25% of his gross income from his return. Sec. 6501(e). See Richards, "The Extended Statute of Limitations on Assessments," 12 Tax L.Rev. 297 (1957). Cf. Altman, "How Long Do You Keep Your Tax Records?" 24 Taxes 98 (1946). By sec. 6503(a), the period for assessment is suspended after a notice of deficiency is sent to the taxpayer until the period for filing a petition in the Tax Court has expired; and if a petition is filed, the period continues to be suspended until the decision of the Tax Court becomes final (as defined in sec. 7481), and for sixty days thereafter.[4]

Notes

Under sec. 6501(c)(3) of the 1954 Code, no statute of limitations runs where "no return" is filed. In *Automobile Club of Michigan v. Commissioner,* 353 U.S. 180 (1957), it appeared that the Commissioner had ruled in 1934 that the taxpayer was a "club" and exempt from tax under the provision which is now found in Section 501(c)(7) of the 1954 Code. This ruling was confirmed in a letter sent in 1938. In 1945, the Commissioner revoked these rulings and required the taxpayer to file returns for 1943 and subsequent years. He fixed 1943 as the first taxable year under the provision of the 1939 Code (sec. 3791(b)) which corresponds with sec. 7805(b) of the 1954 Code. These returns were filed on October 22, 1945, and a deficiency was determined within three years of that date. The Court held that this deficiency was not barred by the statute of limitations. The statute of limitations did not begin to run until returns were filed, even though the reason no regular tax returns were filed was because of the Commissioner's rulings that the taxpayer was exempt. The Court also held that information returns filed by the taxpayer on Form 990, which were all that the taxpayer was required to file during the years in question, did not serve to start the running of the statute of limitations.

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[4] In computing these periods, the day on which the return is filed or the tax is paid is excluded. Thus, if a return was filed on March 15, 1954, March 15, 1957 is within the three-year period, and March 16 is outside. See Burnet v. Willingham Loan & Trust Co., 282 U.S. 437 (1931). As to the time when the tax is paid, where the taxpayer makes a deposit prior to the time the tax is determined or assessed, see Rosenman v. United States, 323 U.S. 658 (1945). But see Hanley v. United States, 105 Ct.Cl. 638, 63 F.Supp. 73 (1945).

Although this decision is significant in showing the approach of the Court to problems of this sort, it is important to note that the result has been changed with respect to 1954 and later years which are subject to the Internal Revenue Code of 1954. Under sec. 6501(g)(2), the filing of an information return on Form 990 is now sufficient to start the running of the statute of limitations.

Under sec. 6501(e)(1)(A)(ii) the extended period does not run, even though the item is omitted from gross income on the return if the facts are disclosed in the return. The same result was reached under the 1939 Code, without an express statutory provision to that effect. *The Colony, Inc. v. Commissioner,* 357 U.S. 28 (1958).

Assessment and Collection

The word assessment is a term of art in tax law. It is the formal act of the Commissioner which fixes the government's tax claim. "An assessment is made on the date when the assessment list is signed by the Commissioner." Mim. 3229, III–2 Cum.Bull. 293, 294 (1924). If the tax is properly assessed, it may be collected at any time within six years after assessment. See sec. 6502 (a) of the 1954 Code. But if it is not assessed in time, collection, either directly, or by suit in court is barred. The government does not have to rely on court proceedings to collect the tax. If the tax has been validly assessed, it may be collected administratively by distraint. See sec. 6331 of the 1954 Code. This is a drastic but effective remedy.

Jeopardy Assessments

In general, the government cannot assess any income, estate, gift, or excess profits tax until it has sent the taxpayer a notice of deficiency, and the opportunity given to the taxpayer to have the deficiency redetermined by the Tax Court has either been waived or has expired, or, if the taxpayer files a petition in the Tax Court, until that Court's decision becomes final. But, "If the Secretary or his delegate believes that the assessment or collection of a deficiency . . . will be jeopardized by delay, he shall . . . immediately assess such deficiency . . ." See secs. 6861, 6862 of the 1954 Code. This is known as a jeopardy assessment. The taxpayer may appeal to the Tax Court, but this does not stay the government's right to collect the tax. This may be done only by filing a bond. See sec. 6863 of the 1954 Code. Compare the right of the government to close the taxpayer's taxable year under sec. 6851 of the 1954 Code. These sections are useful, among other cases, in the collection of income taxes from foreign prize fighters, or sweepstakes winners. See Karminsky, "Administrative Law and Judicial Review of Jeopardy Assessments under the Internal Revenue Code," 14 Tax L.Rev. 545 (1959). For the procedure in cases of bankruptcy and receiverships, see sections 6871–6873 of the 1954 Code.

TEEL v. COMMISSIONER

United States Court of Appeals, Tenth Circuit, 1957. 248 F.2d 749.

PICKETT, CIRCUIT JUDGE. This is a petition to review a decision of the Tax Court dismissing a petition for a redetermination of a tax deficiency for the reason that it was not filed within 90 days from the date of the mailing of the notice of deficiency to the taxpayer. § 272 of the Internal Revenue Code of 1939, provides that when the Commissioner determines a tax deficiency, he is authorized to send a notice of the same to the taxpayer by registered mail. "Within ninety days after such notice is mailed", the taxpayer may file with the Tax Court of the United States a petition for redetermination of the deficiency. In case of a joint return filed by a husband and wife, the notice of deficiency may be a single joint notice. The mailing of the notice to the taxpayer at his last known address shall be sufficient even if such taxpayer is deceased or is under a legal disability.[1] Treasury Regulation 118, § 39.272–1 is substantially the same as the statute.

The question of whether the petition for redetermination was filed within the statutory time is presented here on an agreed statement of facts. On August 9, 1955, the petitioners, husband and wife, were actually residing at 2340 Oneida Street in Salt Lake City, Utah. On that date the Commissioner of Internal Revenue, through the Utah District Director of Internal Revenue, mailed a notice of tax deficiency for the year 1952 to the petitioners at the above address. The mailing was by registered mail but the postman was unable to make delivery to either of the petitioners at the address shown on the envelope so he left a notice that the post office was holding a registered letter for them. Thereafter, on August 15, 1955, a second notice was mailed to the petitioners by the postal authorities, advising them that registered mail was being held for delivery to them. The letter was not called for by either of the petitioners and the Post Office Department returned it to the Director's office on August 22, 1955. An agent of the Commissioner telephoned the petitioner Theron C. Teel at his business office and informed him that he had the letter containing the notice before him and asked Teel what he wished him to do with it. Teel requested the agent to send the letter on to his business office. To accomplish this, the agent scratched out the original address on the envelope and, in his own handwriting, wrote in the address of the petitioner's office. The envelope containing the notice was then returned to the postal authorities and was delivered to the petitioner on August 23, 1955, by using the same registration number and

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1 The provisions of the Internal Revenue Code of 1954 are substantially identical. 26 U.S.C.A. § 6212 and § 6213.

without re-registering the letter. On the envelope were notations that two notices were left at the address shown thereon, together with the dates thereof. Petitioners say that they did not receive these notices. It is agreed that the petition for re-determination was not filed within 90 days from August 9, 1955, but was within time if the date of mailing is considered to be August 22, 1955, the date on which the envelope containing the notice was forwarded to the taxpayers.

The courts have generally held that the filing of the petition is jurisdictional, and that a failure to file the petition within the 90 day period is a bar to consideration by the Tax Court. Dolezilek v. Commissioner, 94 U.S.App.D.C. 97, 212 F.2d 458; Mindell v. Commissioner, 2 Cir., 200 F.2d 38; Central Paper Co. v. Commissioner, 6 Cir., 199 F.2d 902; Di Prospero v. Commissioner, 9 Cir., 176 F.2d 76; Ryan v. Alexander, 10 Cir., 118 F.2d 744, certiorari denied 314 U.S. 622; Continental Petroleum Co. v. United States, 10 Cir., 87 F.2d 91, certiorari denied 300 U.S. 679.

The petitioners contend that when the notice was mailed to the business address of the husband on August 22, 1955, the original mailing was abandoned and the petitioners were misled into believing that the 90 day period commenced to run as of the later date. They rely upon Eppler v. Commissioner, 7 Cir., 188 F.2d 95, 98. We think that case is distinguishable upon the facts. In the Eppler case there was a re-registration and mailing. It does not appear that there was any knowledge on the part of the taxpayer that it had been previously mailed. The court there stated that "by mailing out the notice of deficiency the second time by registered mail the taxpayer was given no notice of the first mailing and he was therefore misled into believing that he had ninety days from the second mailing within which to file his appeal." The first mailing was not to the actual address of the taxpayers. There was no personal contact between the taxpayers and representatives of the Commissioner. In the instant case the taxpayers had notice of the previous mailing, not only from the notations and postmarked dates stamped on the envelope, but from an agent of the Director who forwarded it at taxpayer's request and for taxpayer's convenience. There is no merit to the contentions of the taxpayers that the first mailing was abandoned and that they were misled because the letter was returned to the post office for forwarding on to them. The decisions are overwhelming that the 90-day period begins to run from the date of the mailing of the deficiency notice, not from its actual receipt. Glavin v. Commissioner, 2d Cir., 239 F.2d 166; Kiker v. Commissioner, 4 Cir., 218 F.2d 389; Underwriters, Inc., v. Commissioner, 3 Cir., 215 F.2d 953; Arkansas Motor Coaches, Ltd. v. Commissioner, 8 Cir., 198 F.2d 189; Ryan v. Alexander, supra.

The petition not having been filed within 90 days after such notice was mailed, the Tax Court was without jurisdiction to consider the same and it was properly dismissed.

Affirmed.

Notes

(A) After a deficiency notice is issued, the taxpayer has ninety days within which to file a petition with the Tax Court for a review of the Commissioner's decision. See sec. 6213(a) of the 1954 Code. Until 1954, it was incumbent on the taxpayer to see that his petition was actually received by the Clerk of the Tax Court in Washington within the ninety days. Under sec. 7502 (see especially sec. 7502(d)) of the 1954 Code, however, a petition is regarded as filed on time if mailed on time, and actually delivered. It still seems to be good practice to see that the petition is actually received by the Clerk of the Tax Court within the prescribed time.

For example, when a petition was mailed but was received by the Tax Court after the due date with no date stamp on the envelope, it was held that it was too late and the Tax Court had no jurisdiction. *Luther A. Madison,* 28 T.C. 1301 (1957). Simiarly the statute requires a "United States postmark." Where the petition was mailed on time in Cuba it was held that it was too late when received after the time for filing had expired. *Luis Cespedes,* 33 T.C. 214 (1959).

In *Edward Barron Estate Co. v. Commissioner,* 93 F.2d 751 (C.C.A.9th, 1937), a skeleton telegraphic petition reaching the chairman of the Board by telephone on the evening of the last day was held insufficient. But in *McCord v. Commissioner,* 123 F.2d 164 (App.D.C.1941), a telegraphic petition was sustained. Rule 7 of the Rules of the Tax Court now provides: "No telegram, cable, radio, or similar message will be recognized as a petition." The new statutory provision does not extend to telegraphic petitions.

See Weiss, "When is a Petition 'Filed' in the Tax Court?" 8 Tax L.Rev. 473 (1953).

(B) Where a petition is filed too late, may the government issue a second notice of deficiency? *Cf.* sec. 6212(c) of the 1954 Code. If such a notice were issued, would the Tax Court have jurisdiction of the whole deficiency, including that determined by the first notice?

(C) Since August 15, 1945, the Tax Court has been closed all day on Saturdays. By the Act of December 29, 1945, the Code was amended so as to provide that "Saturday, Sunday, or a legal holiday in the District of Columbia" should not be counted as the 90th day for the purpose of determining whether a petition was filed on time. See, now, sec. 6213(a) of the 1954 Code. Notice that the period is 150 days if the deficiency notice is addressed to a person "outside the States of the Union and the District of Columbia."

(D) Under sec. 6512(a) of the 1954 Code if the taxpayer files a timely petition with the Tax Court "no credit or refund . . . shall be allowed or made and no suit by the taxpayer

for the recovery of any part of the tax shall be instituted in any court" except in accordance with the final decision of the Tax Court. This means that the filing of a petition with the Tax Court constitutes a binding election by the taxpayer to be governed by the decision of the Tax Court. This was applied in *Elbert v. Johnson,* 164 F.2d 421 (C.C.A.2d, 1947), to bar a suit in the District Court even though the Tax Court had held that it did not have jurisdiction to consider a set-off claim advanced by the taxpayer there as a defense against a deficiency determined by the government.

Issue: whether there was a deficiency that could be heard by the Tax Ct [illegible]

BENDHEIM v. COMMISSIONER

Court of Appeals, Second Circuit, 1954. 214 F.2d 26.

MEDINA, CIRCUIT JUDGE. The taxpayer's petition for review presents a narrow procedural question affecting the jurisdiction of the Tax Court.

Having filed an income tax return indicating no tax liability whatever for 1943, the taxpayer was notified on March 17, 1947, by the Internal revenue agent in charge for the Upper New York Division, that a deficiency in the amount of $17,582.87 was being proposed. Within the thirty-day period following the receipt of the letter proposing this deficiency, the taxpayer filed a protest, and certain conferences and the submission of supplementary material ensued. On May 25, 1950, the taxpayer transmitted to the Collector of Internal Revenue for the Third District of New York the sum of $24,000 with the following letter:

> I enclose herewith my check to your order in the sum of $24,000.00 representing payment of personal income tax for the calendar year 1943 in the amount of $17,500.00 and interest thereon at the rate of 6% per annum in the sum of $6,500.00.
>
> I would appreciate your stamping the copy of this letter as my receipt.

This sum was placed by the Collector in his Suspense Account and the payment of $17,500 of income tax for 1943 was overlooked when, upon conclusion of the administrative processing of the matter, the taxpayer having filed no waiver as provided in Section 272(a) of the Internal Revenue Code, the Commissioner sent the taxpayer a letter on February 15, 1951, in the regular form of deficiency 90-day notice in the amount of $17,432.29. The difference between the deficiency originally proposed and that stated in the letter of February 15, 1951, is accounted for by the fact that the taxpayer had been given certain credits based upon information in the various papers submitted.

The taxpayer contends that there was a "deficiency," within the meaning of Section 271 of the Internal Revenue Code, and that, even if no "deficiency" in fact existed, the letter from the

Commissioner constituted a determination that there was a deficiency sufficient to give the Tax Court jurisdiction, as provided in Section 272.

Section 271 defines a "deficiency" for the purposes of the Tax Court's jurisdiction as the amount by which the tax imposed by the statute exceeds the sum of the amount shown on the return, plus amounts assessed or collected without assessment, over the amount of rebates as defined in subsection (b) (2). The taxpayer claims that "collected without assessment" are words of art which refer only to payments made pursuant to a judgment obtained by the Government in a court proceeding. Thus construed, the payment of $17,500 would be disregarded in making the computation required by the statute in order to determine whether or not the Tax Court had jurisdiction. The amount shown on the return was zero, no rebates are involved and a "deficiency" thus exists, according to the taxpayer's argument, because, as he says, the $17,500 was not "collected without assessment." While ingenious we do not find this argument convincing, as the amount in question here was certainly "collected without assessment," and it will suffice to say that the various quotations from cases and other material relied on by the taxpayer have little if any relevancy to the question before us for decision. It would serve no useful purpose to discuss them in extenso.

As the additional tax in dispute had already been paid there was no "deficiency"; and the legal effect of the Commissioner's letter was to assert a liability by the taxpayer for taxes which were due only in the sense that there remained such remedies as might be pursued by the taxpayer according to law before a determination relative thereto would be final. The Commissioner's letter obviously was an oversight, and was not a valid notice of deficiency within the meaning of Section 271.

Moreover, the claim made by the taxpayer's counsel on the oral argument before us to the effect that the amount paid was deliberately fixed by the taxpayer at $17,500, or $82.87 less than the amount proposed by the internal revenue agent, so that there would necessarily be a "deficiency" to confer jurisdiction upon the Tax Court, does no more than emphasize the wisdom of a clear-cut rule. In any event, and by sheer accident, as it appears, the amount actually found by the Commissioner to be due was less than $17,500.

We are content to follow the reasoning of Judge Dobie, writing for the Fourth Circuit in *McConkey v. Commissioner of Internal Revenue,* 199 F.2d 892 (1952), where the facts were identical with those here. The taxpayer has two independent procedures open to him, with advantages and disadvantages in each. He should not be entitled to pick and choose a little from each for

his benefit but should be restricted to the pursuit of either in an orderly manner. The payment of the amount claimed to be due is the prerequisite to a suit in a federal court for a refund. That remedy is still open to the taxpayer here. Whatever may be said for the desirability of holding government agents to the letter of official communications, especially in the routine of tax assessment and collection, we can see no point in holding that the Tax Court must assert jurisdiction upon the basis of the mistake made by the Commissioner here.

Affirmed.

Notes

(A) Suppose the taxpayer had paid $17,400 to the collector, rather than $17,500, thus leaving a small deficiency rather than an overpayment. Would the Tax Court have had jurisdiction? Can a taxpayer minimize his liability for interest by paying, say, 95% of the liability stated in a deficiency letter before filing his petition, and still invoke the jurisdiction of the Tax Court?

A recent case considering the question whether there is a deficiency as a prerequisite to the jurisdiction of the Tax Court is *Charles E. Myers, Sr.*, 28 T.C. 12 (1957).

Once the deficiency letter has been mailed, payment of the tax may be made without depriving the Tax Court of jurisdiction. See sec. 6213(b) (3) of the 1954 Code.

(B) Suppose the government determines a deficiency in income tax and an overassessment of excess profits tax for the same year, with a net deficiency of the two—that is, the deficiency in income tax is greater than the overassessment of excess profits tax. The Tax Court has jurisdiction only over the deficiency of income tax. It has no jurisdiction with respect to the excess profits tax, since there is no deficiency in excess profits tax, and the two taxes (as imposed in 1940–1945) were treated separately for jurisdictional purposes. *Pioneer Parachute Co.*, 4 T.C. 27 (1944).

Although the Tax Court's jurisdiction can be based only on a deficiency, once the case is in the Tax Court, that Court has complete jurisdiction over all aspects of the particular tax before it. Thus, the government may, by its answer, or amended answer, seek an increase in the deficiency over that stated in the deficiency letter. See sec. 6214(a) of the 1954 Code. This fact should be borne in mind before filing a petition with the Tax Court. For a case where it was overlooked with catastrophic consequences, see *du Pont v. Commissioner*, 118 F.2d 544 (C.C.A. 3d, 1941), cert. den. 314 U.S. 632 (1941). The Tax Court can, however, render a decision only with respect to the tax year or years involved in the deficiency notice which it is reviewing. See section 6214(b) of the 1954 Code.

If a suit for a refund is pending before a district court or the Court of Claims, the Commissioner may nevertheless determine that there is a deficiency in the taxpayer's tax. If a deficiency letter is issued before the trial of the refund case, the trial is stayed during the period within which the taxpayer may file a petition with the Tax Court, and if a petition is filed, the district court (or the Court of Claims) is ousted of jurisdiction. See sec. 7422(e) of the 1954 Code. If the Tax Court acquires jurisdiction, the whole controversy may be decided there.

Where a deficiency letter has been issued and a petition has been filed with the Tax Court, the Tax Court has jurisdiction to determine, if the facts warrant it, that there has in fact been an overpayment and that the taxpayer is entitled to a refund. Suppose the Commissioner refuses to pay an overpayment found by a decision of the Tax Court which has become final? Does the taxpayer have any remedy? May he bring mandamus against the Commissioner, or sue in the Court of Claims?

The Tax Court does not have jurisdiction over interest. In *Commissioner v. Kilpatrick's Estate,* 140 F.2d 887 (C.C.A.6th, 1947), the Tax Court found that there had been an overpayment of tax, but refused to include anything in its order to the effect that there had been an overpayment of interest. This was sustained on appeal. If the Commissioner does not pay the interest may the taxpayer sue for it in Court?

Either party may obtain review of the Tax Court's decision from the appropriate Court of Appeals. See sec. 7482 of the 1954 Code; *Industrial Addition Ass'n v. Commissioner,* 323 U.S. 310 (1945).

Review by the Supreme Court in all federal tax cases, whether originating before the Tax Court when deficiency notices have been issued, or in the District Courts or the Court of Claims in refund cases, is ordinarily only by writ of certiorari.[1] See Title 28, United States Code, sec. 1254(1). Certiorari is granted by the Supreme Court in only a small proportion of the tax cases in which it is sought—recently less than 10%; and a considerable proportion of these are granted on the Government's petition—

[1] In addition to review by the Supreme Court on a writ of certiorari, there are two other methods by which a case may get to the Supreme Court. One is by "certificate" under Title 28, United States Code, sec. 1254(3). This is a very rare device, almost non-existent in recent years. It was the procedure followed in Old Colony Trust Co. v. Commissioner, on page 204 of the casebook. The other method is by direct appeal from the District Court (or any other court) when that court has held an act of Congress to be unconstitutional. See Title 28, United States Code, sec. 1252. This was the procedure followed in Fernandez v. Wiener, 326 U.S. 340 (1945).

which is natural, since the Government is better able to select the cases in which it will file petitions than are the taxpayers. See Report of the Attorney General, 1939, pp. 27–28. The Court's own formulation of the situations in which certiorari will be granted is found in Rule 19 of the newly revised Rules of the Supreme Court (1954). But certiorari is sometimes granted in situations which do not seem to come within the rules, so that the tax practitioner often finds it difficult not to take the chance. See the vigorous dissenting opinion in *Deputy v. du Pont*, 308 U.S. 488, 499 (1940).[2]

Partnership in bad shape & found that [illegible] unrecorded [illegible]

BURKA v. COMMISSIONER

Court of Appeals, Fourth Circuit, 1950. 179 F.2d 483.

SOPER, CIRCUIT JUDGE. The petitioning taxpayers were equal partners in a laundry business in Washington, D. C. during the taxable year 1944. They seek a review of a determination of deficiencies in income tax growing out of a finding that the distributable net income of the partnership for the year should be increased by the sum of $12,508.93.

During the year 1944, the business of the laundry grew rapidly and the books of the firm were not accurate or complete, but were in a state of great confusion. Accordingly, the firm employed a certified public accountant in the fall of the year and turned over to him its available records which included bank books, cancelled checks and sales sheets. The accountant endeavored to reconstruct the income for the first ten months and introduced standard accounting practices for the balance of the year. In reconstructing the income for the period from January 1 to October 31, he assumed that the gross bank deposits represented sales and the gross bank disbursements represented expenses of the business which he endeavored to allocate to running expenses, drawing or capital items.

The trial balance of October 31, 1944, stated by the accountant, showed "unrecorded expense" of $12,463.93. This amount, plus $45 listed as contributions, makes up the deficiency. The larger bills during the year were paid by check but the smaller bills for supplies, gas, oil and lost laundry were paid in cash by one or another of the partners. Some of these items, but not all of them, were recorded on the reverse side of sales sheets which were prepared by six or seven different employees who were changed from time to time during a rapid turnover. These notations amounted to $6,368.12 during the five months prior to October 31. There were no such notations on the sales slips for the

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[2] See Boskey, "Mechanics of the Supreme Court's Certiorari Jurisdiction," 46 Col.L.Rev. 255 (1946).

first five months of 1944. To meet this situation the accountant in his endeavor to show the true income of the firm set up an account which he designated "unrecorded expense." He credited this account with the sum of $500 representing checks marked petty cash, but not broken down as to items, $595.81 representing checks marked supplies for rug department not used in 1944, and also the above sum of $6,368.12 making a total of $7,463.93. He also concluded that similar expenses must have been incurred, although not recorded, during the first five months, and he credited the additional sum of $5,000 to unrecorded expenses for this period. Accordingly the trial balance for October 31, 1944 showed the item of $12,463.93 for unrecorded expense; and since the accountant concluded that these expenditures were made from unrecorded cash receipts, it was necessary for him to increase the sales by a corresponding amount on the balance sheet.

When the accountant made his trial balance for December 31, 1944, he decided that he had been wrong in arbitrarily estimating the unrecorded expense as $5,000 for the first five months since there were no supporting records and accordingly he eliminated the $5,000 item of unrecorded expense and the corresponding $5,000 credit to sales.

The Commissioner accepted the conclusions of the accountant that the income of the partnership should be increased by the sum of $12,463.93 since the evidence indicated that this amount had been expended and must have been derived from the undeposited cash receipts of the business; but the Commissioner rejected the accountant's conclusion that this sum represented deductible expenses of the business. He disallowed these deductions since they were not accurately recorded or supported by the evidence and could have included withdrawals by the partners as well as other non-deductible items.

The Tax Court refused to disturb the Commissioner's determination. It pointed out that the taxpayers failed to produce their vouchers or even the accountant's work sheets and that the conclusions of the accountant were based upon estimates rather than reliable records. For example, the accountant made journal entries on the books of the firm indicating that the unrecorded expense for the five months ending October 31, in the sum of $7,463.93 was made up of $1,000 for payment of claims, $2,000 auto expenses, and $4,463.93 for supplies; but, it was conceded, these sums were mere estimates on the part of the accountant and that there were no vouchers or listings of any kind to support the entries.[1]

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[1] Despite these disallowances, the petitioners were allowed deductions in the sum of $16,000 for supplies, $1,200 for auto expenses and $1,000 for the payment of claims.

We are in accord with these conclusions. The Commissioner's disallowance of the deductions was presumptively correct and the burden was on the taxpayers to overcome it. Their evidence, however, shows that they failed to keep an adequate account of their receipts and disbursements as contemplated by Section 54 (a) of the Internal Revenue Code, and that in consequence their records were in extremely bad shape. Moreover, the taxpayers failed to produce such books and vouchers as they kept or even the accountant's work sheets, and failed to give a satisfactory explanation of the absence of these records. The Commissioner was therefore at liberty to resort to the best procedure available under the circumstances in making his determinations, and to adopt the method used by the taxpayers' accounting in arriving at the amount of the gross income; *Richards v. Commissioner,* 5 Cir., 111 F.2d 374; but the Commissioner was not bound to adopt the accountant's conclusion that the unrecorded expense represented deductible items. The amount of the unrecorded expense and its proper allocation were the result of the accountant's estimates and neither the Commissioner nor the court was obliged to accept this estimate or to give credit to the testimony of the taxpayers which was likewise unsupported by detailed records. It is true that the Tax Court may not arbitrarily reject well substantiated testimony; but it is not bound to accept the estimates of interested witnesses under such circumstances as prevail in this case. *Greenfield v. Commissioner,* 4 Cir., 165 F.2d 319.

The decision of the Tax Court is therefore

Affirmed.

Notes

(A) As this case illustrates, the burden of proof is ordinarily on the taxpayer. Any determination made by the Commissioner is presumptively correct, and he does not need to produce evidence to support it. See Caldwell, "Non-Income Items in Deposits," 29 Taxes 65 (1951).

(B) The method of proving income by showing increases in net worth is often used in criminal tax cases. See, e. g., *Holland v. United States,* 348 U.S. 121 (1954). It can also be used in civil cases to collect a deficiency and penalties. For discussions, see Burns and Rachlin, "Trial by Net Worth," 33 Taxes 121 (1955); Mehlman, "The Motion for a Sound and Better Statement in Net Worth Fraud cases," 10 Tax L.Rev. 267 (1955); Avakian, "Net Worth Computations as Proof of Tax Evasion," 10 Tax L.Rev. 431 (1955); Mills, "The Net Worth Approach in Determining Income," 41 Va.L.Rev. 927 (1955); De Pietro, "The *Holland* Case—An Analysis," 35 Taxes 224 (1957).

(C) There are certain situations where the burden of proof is on the government. These are (1) with respect to new matter raised by the government in its answer before the Tax Court, (2) with respect to the issue of fraud, and (3) in transferee proceedings, where the burden is on the government "to show that

a petitioner is liable as a transferee of property of a taxpayer, but not to show that the taxpayer was liable for the tax." See Rule 32 of the Rules of the Tax Court, and secs. 7454(a) and 6902 of the 1954 Code. See Marcosson, "The Burden of Proof in Tax Cases," 29 Taxes 221 (1951); Lipton, "Recent Civil Fraud Cases—Problems of Burden of Proof," 31 Taxes 110 (1953). See also Rice, "Tax, Fact and Fiction: Presumptions in Tax Cases," 1 South Dakota L.Rev. 56 (1956); Ness, "The Role of Statutory Presumptions in Determining Federal Tax Liability," 12 Tax L.Rev. 321 (1957).

A new situation in which the burden of proof may be on the government has been introduced in the Internal Revenue Code of 1954. This is in secs. 531–536 of that Code imposing a tax on corporations which improperly accumulate surplus. If the proper procedural steps are followed, the burden of proving that an accumulation is improper is on the government. Sec. 534.

HELVERING v. TAYLOR

Supreme Court of the United States, 1935. 293 U.S. 507.

MR. JUSTICE BUTLER delivered the opinion of the Court.

The commissioner determined a deficiency of $9,156.69 on account of respondent's 1928 income tax. The Board of Tax Appeals made the same determination. The court held it excessive and that the evidence did not show the correct amount, reversed the order of the board and remanded the case for further proceedings in accordance with the opinion. 70 F.2d 619. The petition for our writ states the question: "Whether the Circuit Court of Appeals erred in remanding this case to the Board of Tax Appeals for a new hearing on the ground that the Commissioner's determination of the amount of income was incorrect, although the taxpayer had failed to prove facts from which a correct determination could be made."

In August, 1927, respondent acquired all the stock of four utilities at a total cost of $96,030, organized a holding company and October 13 transferred to it all the utilities stock and received therefor all the shares of the holding company: 1,000 of preferred having no par value, entitled to a dividend of $6 annually, $100 on liquidation and callable at $105 per share; 2,500 of no par value class A common callable at $35 per share; 5,000 of no par value class B common stock having the voting power. As this transaction was "reorganization" under Revenue Act of 1926, sec. 203(b) (2), 44 Stat. 12, no taxable gain resulted.

In May, 1928, the holding company sold the stock of the four utilities to the Colonial corporation for $194,930.16. Later in that year the holding company bought or retired all the preferred and paid the taxpayer $99,000 therefor. In his 1928 return he assigned the $96,030 for which he procured the utilities to the preferred stock of the holding company, deducted that amount from

the $99,000 received therefor, and reported the difference, $2,970, as the gain derived from the sale. The applicable statutory provisions are contained in Revenue Act of 1928, secs. 111(a) (d), 112(b) (3), 113(a) (6). 45 Stat. 815–19. They prescribe no rule that is applicable for the ascertainment of the cost of the preferred stock or the apportionment of the total cost beween preferred and common. But Regulations 74, Art. 58, declares: "Where common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost."

The Commissioner, holding the taxpayer not entitled to charge the cost of all to the preferred, apportioned between the preferred and common. He made his calculation upon the assumption that the cost, in 1927, attributable to the preferred shares bears the same relation to cost of all the shares then acquired as the amount respondent received, in 1928, for the preferred bears to the amount paid the holding company by Colonial corporation for all the utilities shares.[1] On that basis, he found that of the total 1927 cost, $96,030, there was chargeable to the preferred only $48,771.16 which deducted from $99,000 received by respondent for the preferred in 1928, leaves $50,228.84 upon which he determined the deficiency of $9,156.69.

Before the Board of Tax Appeals the taxpayer introduced evidence to show the details of the transaction and that there was no change in value of the utilities stock between the time he got it in August, 1927, and the date, October 13 of the same year, on which he transferred it to the holding company in exchange for its shares and that the entire increase in value came after that transfer. No opposing evidence was offered. On the facts shown, the taxpayer maintained that, as total cost was less than $100 per share for the preferred having prior rights to that extent on liquidation, the common stock had no value. Rejecting that contention, the Board of Tax Appeals filed a memorandum opinion in which it said: "It may well be that the properties acquired or all the classes of stocks received by the petitioner were worth only $96,030 . . . and yet the preferred stock . . . may have had the value of $48,771.16 . . . It is obvious

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[1] The figures are: X : $96,030 : : $99,000 : $194,930.17. The calculation stated in the opinion of the Board of Tax Appeals is:

$$\frac{\$99{,}000.00}{\$194{,}830.17} \times \$96{,}030 = \$48{,}771.16.$$

that even if all the securities were worth only $96,030 that the proportionate value of the preferred stock to all the stocks would not necessarily be different from that determined by the Commissioner. . . . The question . . . is one of fact to be determined by testimony and not theory. It is conceivable that common stocks may actually sell on the market when preferred stocks in the same corporation are selling at less than par." It was upon that basis, without specific findings of fact, that the board made the redetermination at the figure set by the commissioner.

The only question for consideration is that stated in the petition for the writ of certiorari. *Gunning v. Cooley*, 281 U.S. 90, 98. That question in effect assumes, and here it is taken as granted, that the court rightly held the evidence sufficient to require a finding that the commissioner's apportionment of total cost as beween preferred and common stock was unfair and erroneous and that therefore the commissioner's determination was excessive. We also assume that the total purchase price is susceptible of fair apportionment and that upon another hearing the correct amount may be found. 70 F.2d 619, 620. Regulations 74, Art. 58, *supra*. The point to be considered is whether, the taxpayer having failed to establish the correct amount to be assigned to the preferred stock as its cost to him, the court erred in reversing and remanding for further proceedings in accordance with its opinion.

The commissioner does not contend that, in cases where Circuit Courts of Appeals properly reverse determinations of the board they are without power to remand for further hearing in the nature of a new trial.[2] His contention is that in this case the burden on the taxpayer was not only to prove that the commissioner's determination is erroneous but to show the correct amount of the tax. In substance he says that, because of the taxpayer's failure to establish facts on which a fair apportionment may be made, the board's redetermination at the commissioner's erroneous figure was valid and there being no error of law should have been sustained by the court. And he maintains that, in the absence of error on the part of the board, the court was without power to remand for further hearing. . . .

He also cites Rule 30 adopted by the board: "The burden of proof shall be upon the petitioner, except as otherwise provided by statute and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent." But there is

[2] Sec. 1003(b), Revenue Act of 1926, 44 Stat. 110, 26 U.S.C.Sup. VII, sec. 641(c)(1) provides: "Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require."

nothing in it to suggest intention to require the taxpayer to prove not only that a deficiency assessment laid upon him was arbitrary and wrong but also to show the correct amount. Moreover, the board held the evidence not sufficient to show the apportionment erroneous and on that ground alone sustained the assessment. Necessarily the board did not come to the question that is here presented as to burden of proof. The fact that the commissioner's determination of a deficiency was arbitrarily made may reasonably be deemed sufficient to require the board to set it aside. *Cf. Bruce & Human Drug Co.,* 1 B.T.A. 342. *Acorn Refining Co.,* 2 B.T.A. 253. *Index Notion Co.,* 3 B.T.A 90.

The commissioner cites *United States v. Rindskopf,* 105 U.S. 418; *United States v. Anderson,* 269 U.S. 422, 443; *Reinecke v. Spalding,* 280 U.S. 227, 232–233. The first of these may be put aside without discussion as having no bearing upon the point here in controversy. The other two were adequately distinguished by the Circuit Court of Appeals. Each was an action to recover taxes paid. Obviously the burden was on the plaintiff, in order to establish a basis for judgment in his favor, specifically to show not merely that the assessment was erroneous but also the amount to which he was entitled. For like reason the burden is upon the taxpayer to establish the amount of a deduction claimed. *Burnet v. Houston,* 283 U.S. 223, 227. *Helvering v. Ind. Life Ins. Co.,* 292 U.S. 371, 381. *New Colonial Co. v. Helvering,* 292 U.S. 435, 440. . . .

Unquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid. *Lucas v. Structural Steel Co.,* 281 U.S. 264, 271. *Wickwire v. Reinecke,* 275 U.S. 101, 105. *Welch v. Helvering,* 290 U.S. 111, 115. Frequently, if not quite generally, evidence adequate to overthrow the commissioner's finding is also sufficient to show the correct amount, if any, that is due. See, *e. g., Darcy v. Commissioner,* 66 F.2d 581, 585. But, where as in this case the taxpayer's evidence shows the commissioner's determination to be arbitrary and excessive it may not reasonably be held that he is bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him. On the facts shown by the taxpayer in this case, the board should have held the apportionment arbitrary and the commissioner's determination invalid. Then, upon appropriate application that further hearing be had, it should have heard evidence to show whether a fair apportionment might be made and, if so, the correct amount of the tax. The rule for which the commissioner here contends is not consonant with the great remedial purposes of the legislation creating the Board

of Tax Appeals.[3] The Circuit Court of Appeals rightly reversed and remanded the case for further proceedings in accordance with its opinion.

Affirmed.

MR. JUSTICE STONE, dissenting.

I think the judgment should be reversed.

As respondent failed to establish any amount by which the deficiency fixed by the Commissioner should be reduced, the Board of Tax Appeals was without authority, under the statute defining its jurisdiction, to disturb the determination of the Commissioner, c. 27, secs. 274(b) (e), 906(c) (d), 44 Stat. 9, 55, 56, 107; 26 U.S.C., secs. 1048a, 1048c, 1217(c) (d). If, under sec. 906(d), it was the duty of the Board to dismiss the petition and enter on its records a finding that it could not determine the amount of the deficiency, these requirements are formal only. Its failure to comply with them does not require a reversal of its order sustaining the action of the Commissioner or in any case afford ground for decision on appeal that the Board should have held the Commissioner's determination invalid or that it should now take further evidence.

Note

The rule of the *Taylor* case was applied in an interesting situation in *Federal Nat. Bank v. Commissioner,* 180 F.2d 494 (C.A. 10th, 1950). For the Tax Court's disposition on remand see 16 T.C. 54 (1951).

THE DOBSON EPISODE

In 1943, the Supreme Court decided the case of *Dobson v. Commissioner,* 320 U.S. 489. The question there arose with respect to a taxpayer who had purchased stock in 1929. In 1930 and 1931 he sold some of the stock at a loss which he claimed on his return. Later he found that the original sale had not complied with the local Blue Sky Law. He brought suit against the seller. In 1939 the suit was settled, and he received a substantial payment. The question was whether this payment was income. It appeared that the deduction of the loss on the sales in 1930 and 1931 had not given the taxpayer any tax benefit in those years, "for even if the entire deductions claimed on account of these losses had been disallowed, the returns would still have shown net losses." In these circumstances the taxpayer contended that the recovery in 1939 did not result in income. The Commissioner,

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[3] House Report No. 179, p. 7; Senate Report No. 398, pp. 8–9, 68th Congress, 1st Session. Warren Mfg. Co. v. Tait, 60 F.2d 982, 984. Old Colony Tr. Co. v. Comm'r Int. Rev., 279 U.S. 716, 621.

however, held that the amount recovered was income in 1939, and was taxable as ordinary income and not as a capital gain.

The Tax Court decided in favor of the taxpayer, thus adopting the so-called "tax benefit" rule under which the recovery of an item previously deducted does not constitute income unless the deduction produced a tax benefit. The Court of Appeals reversed this decision, saying that the "tax benefit theory" was "an injection into the law of an equitable principle, found neither in the statutes nor in the regulations."

On review by the Supreme Court, the Tax Court's decision was reinstated. The Supreme Court did not, however, pass upon the "tax benefit" question on the merits. On the contrary, it held that the Tax Court's decision should be affirmed simply because the Tax Court had decided that way; it said that "every reason ever advanced in favor of administrative finality applies to the Tax Court." The Court said that the question involved was only one of "proper tax accounting," and that when the decision on such a question did not involve "a clear-cut mistake of law, the decision of the Tax Court must stand."

Following the *Dobson* decision, it became very difficult to get review of many tax questions in the Courts of Appeals or the Supreme Court. One side or the other would say that the *Dobson* rule applied, and that there was nothing to do but affirm the decision of the Tax Court. This was presented in rather striking form in the decision in *John Kelley Co. v. Commissioner,* 326 U.S. 521 (1946). That decision involved two separate cases which had been heard at about the same time by different single judges of the Tax Court. Although the facts were not identical, they were very similar, involving in each case the question whether a particular security was a bond or not, on which depended the question whether a payment with respect to it was deductible as "interest" or non-deductible as a "dividend." The two cases in the Tax Court were decided differently. One went to one Court of Appeals, the other to another. Then they both came to the Supreme Court together. That Court held that the *Dobson* rule applied, and that both Tax Court decisions must be affirmed, although they were very nearly inconsistent.

One of the troubles with the *Dobson* rule was that it was not applied with any certainty. Although the Courts of Appeals were pretty well cowed by it, the Supreme Court still found it possible to reverse a decision of the Tax Court whenever it really wanted to do so. It was not possible to work out any consistent pattern for such actions. Another difficulty with the *Dobson* rule was that illustrated by the *Kelley* case. There are sixteen judges of the Tax Court who ordinarily sit individually. Thus there are in reality sixteen different Tax Courts, and their decisions are

often hard to reconcile. This is not a criticism of the Tax Court. It is a trial tribunal, confronted with many special problems and difficulties. One might have felt that the proper function of the appellate courts was to endeavor to work out the inconsistencies which might develop in the Tax Court's decisions.

The *Dobson* rule is now quite dead. In June, 1948, Congress passed a revision of the Judicial Code. As originally drafted, and passed by the House, this included provisions relating to the Tax Court, and making it a part of the judicial system. These provisions were stricken out by the Senate, but the Senate added in their place an amendment of Sec. 1141(a) of the Internal Revenue Code of 1939. This amendment was accepted by the House. It reads as follows:

"The circuit courts of appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of title 28 of the United States Code, *in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury;* and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of title 28 of the United States Code."

This language is continued in sec. 7482(a) of the 1954 Code. (The italics are the editor's; they indicate the words which were added in 1948.)

Thus the actual decision of the *Dobson* case is overturned. But its problems still remain. It is obvious that the Supreme Court cannot, or will not, decide all important tax questions.[1] Should there be some basis for getting a case into the Supreme Court without waiting for a conflict among the Courts of Appeals? Is there any merit to the suggestion that the Supreme Court should take a case in which a Court of Appeals has reversed a decision by the *full bench* of the Tax Court, as distinguished from a memorandum decision or other decision by a single judge of that Court?

The *Dobson* case was analyzed at length in Paul, "Dobson v. Commissioner: The Strange Ways of Law and Fact," 57 Harv.L.

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[1] Cf. Mr. Justice Frankfurter in McDonald v. Commissioner, 323 U.S. 57, 64 (1944): "Having regard to the controversies which peculiarly call for this Court's adjudication and to the demands for their adequate disposition, as well as to the exigencies of litigation generally, relatively few appeals from Tax Court decisions can in any event come here. That court of necessity must be the main agency for nation-wide supervision of tax administration. Whatever the statutory or practical limitations upon the exercise of its authority, Congress has plainly designed that tribunal to serve, as it were, as the exchequer court of the country. Due regard for these considerations is the underlying rationale of Dobson v. Commissioner, 320 U.S. 489."

Rev. 753 (1944). For a discussion of the situation, since 1948, see Rice, "Law, Fact and Taxes: Review of the Tax Court Decisions under Section 1141 of the Internal Revenue Code," 51 Col.L.Rev. 439 (1951).

The question remains whether (particularly since the Court will not accept any appreciable number of tax cases) some better system cannot be devised than the present inverted pyramid of review by eleven Courts of Appeals, and decisions by the Court of Claims. See Griswold, "The Need for a Court of Tax Appeals," 57 Harv.L.Rev. 1153 (1944). *Cf.* Miller, "Can Tax Appeals be Centralized?" 23 Taxes 303 (1945); Report of the Committee on Federal Judicial and Administrative Procedure, in the Program and Committee Reports of the Section of Taxation of the American Bar Association 69 (1945).[2] Discussions of the question continue. See Pope, "A Court of Tax Appeals: A Call for Re-examination" 39 A.B.A.J. 275 (1953); Miller, "The Courts of Last Resort in Tax Cases: A Specialized Court of Tax Appeals?" 40 A.B.A.J. 563 (1954); Nevitt, "Achieving Uniformity Among the 11 Courts of Last Resort," 34 Taxes 311 (1956).

See also, Eisenstein, "Some Iconoclastic Reflections on Tax Administration," 58 Harv.L.Rev. 477 (1945); Cann, "Mistaken Beliefs about Tax Administration," 23 Taxes 55 (1954).

One of the problems which arises from our "inverted pyramid" system of review of tax decisions is that the Tax Court is confronted with a problem when one of its decisions has been reversed by a Court of Appeals. Of course the decision of the Court of Appeals is controlling in the particular case. However, should the Tax Court defer to it in other cases which may be reviewable by other Courts of Appeals? What should it do in the case of another taxpayer who can take his appeal to the same Court of Appeals? The Sixth Circuit Court of Appeals has severely criticized the Tax Court for failing to follow the decision of that Court of Appeals in a subsequent case. *Stacey Manufacturing Co. v. Commissioner*, 237 F.2d 605 (C.A.6th, 1956). Following this, the Tax Court has issued an opinion, reviewed by the full Court,

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2 An earlier proposal for revision of Internal Revenue procedure and court review of tax cases is Traynor, "Administrative and Judicial Procedure for Federal Income, Estate annd Gift Taxes—A Criticism and a Proposal," 38 Col.L.Rev. 1393 (1938). This article provoked numerous replies. See Surrey, "The Traynor Plan—What It Is," 17 Taxes 393 (1939); Younquist, "Proposed Radical Changes in the Federal Tax Machinery," 25 A.B.A.J. 291 (1939); Prettyman, "Comment on the Traynor Plan for Revision of Federal Tax Procedure," 27 Georgetown L.J. 1038 (1939); Angell, "Procedural Reform in the Judicial Review of Controversies Under the Internal Revenue Statutes; An Answer to a Proposal," 34 Ill.L.Rev. 151 (1939). See also Surrey, "Some Suggested Topics in the Field of Tax Administration," 25 Wash.U.L.Q. 399, 400–423 (1940); Traynor and Surrey, "New Roads Toward the Settlement of Federal Income, Estate and Gift Tax Controversies," 7 Law and Contemporary Problems 336 (1940) and Sutherland, "A Critical Comment" ibid. 359.

in which it undertakes to justify its practice of following its own rule of law even in cases subject to the jurisdiction of a Court of Appeals which has adopted a contrary rule. *Arthur L. Lawrence*, 27 T.C. 713 (1957), rev'd on other grounds, 258 F.2d 562 (C.A.9th, 1958). Thereafter, the Seventh Circuit has joined in criticism of the Tax Court, and the Sixth Circuit has reaffirmed its criticism. *Sullivan v. Commissioner*, 241 F.2d 46 (C.A.7th, 1957); *Stern v. Commissioner*, 242 F.2d 322 (C.A.6th, 1957). See 70 Harv.L.Rev. 1313 (1957); "Heresy in the Hierarchy: Tax Court Rejection of Court of Appeals Precedents," 57 Col.L. Rev. 717 (1957).

INCOME TAX

CHAPTER 3

INTRODUCTION

The background and development of the Sixteenth Amendment present an important chapter in American social history. A few of the high points have been referred to in the early pages of this book. The detailed history of the income tax may be found in two excellent books. The first is Seligman, The Income Tax (2d ed., 1914), which deals with the period down through the adoption of the Sixteenth Amendment. The second is a comprehensive history of the tax as it existed under that Amendment down to the Second War. Blakey, The Federal Income Tax (1940). Both contain much valuable information from the political and economic points of view, of the sort which lawyers are too likely to overlook. A more recent examination of basic problems in the Federal tax field is Blough, The Federal Taxing Process (1952). See, also, the basic work: Paul, Taxation in the United States (1954).

For general background reading, see Magill, Taxable Income (Rev. ed., 1945), and Stanley and Kilcullen, The Federal Income Tax (3d ed. 1955). See also Lowndes, "A Brief Introduction to the Federal Income Tax," 1959 Duke L.J. 1; Paul, Taxation for Prosperity (1947); Magill, The Impact of Federal Taxes (1943).

Constitutional Questions

There have been some constitutional hurdles in federal income taxation, and doubtless there will be some others in days to come. Just at present they do not seem nearly as important as they did a while ago. The basic cases are *Flint v. Stone Tracy Co.,* 220 U.S. 107 (1911), and *Brushaber v. Union Pacific Railroad,* 240 U.S. 1, (1916). The first sustained the constitutional validity of the corporation excise tax of 1909, a tax imposed *on* the privilege of doing business in corporate form *measured by* income. This case is notable now chiefly because of the impetus it gave to the quaint but useful constitutional distinction between the subject and the measure of a tax. The *Brushaber* case, which is set out at pp. 44–49, above, sustained the income tax imposed in

1913 under the Sixteenth Amendment. Since that time, constitutional questions have played a relatively minor role in the actual practice of federal taxation.[1]

During the first twenty-five years of the income tax, a constantly recurring question was the problem of inter-governmental immunities. This went back to *McCulloch v. Maryland,* 4 Wheat. 316 (1819). See 4 Beveridge, Life of John Marshall, c. VI (1919). We have already seen its early application to a federal income tax in *Collector v. Day, supra,* p. 25.

HELVERING v. GERHARDT

Supreme Court of the United States, 1938. 304 U.S. 405.

MR. JUSTICE STONE delivered the opinion of the Court.

The question for decision is whether the imposition of a federal income tax for the calendar years 1932 and 1933 on salaries received by respondents, as employees of the Port of New York Authority, places an unconstitutional burden on the States of New York and New Jersey.

The Port Authority is a bi-state corporation, created by compact between New York and New Jersey, Laws of N. Y., 1921, c. 154; Laws of N. J., 1921, c. 151, approved by the Congress of the United States by Joint Resolution of August 23, 1921, c. 77, 42 Stat. 174. The compact authorized the Authority to acquire and operate "any terminal or transportation facility" within a specified district embracing the Port of New York and lying partially within each state. . . .

The Port Authority collects tolls for the use of the bridges and tunnels, and derives income from the operation of the bus line and terminal building, but it has no stock and no stockholders, and is owned by no private persons or corporations. Its projects are all said to be operated in behalf of the two states and in the interests of the public, and none of its profits inure to the benefit of private persons. Its property and the bonds and other securities issued by it are exempt by statute from state taxation. The Joint Resolution of Congress consenting to the comprehensive plan of port improvement, Pub.Res.No.66, 67th Cong., H.J.Resolution No. 337, July 1, 1922, declares that the activities of the Port Authority under the plan "will the better promote and facilitate commerce between the States and between the States and foreign nations and provide better and cheaper transportation of property and aid in providing better postal, military, and other services of value to the Nation." Statutes of New York and New

[1] For an excellent survey of constitutional problems in the tax field, see Lowndes, "Current Constitutional Problems in Federal Taxation," 4 Vanderbilt L.Rev. 469 (1951).

Jersey relating to the various projects of the Port Authority declare that they are "in all respects for the benefit of the people of the two States, for the increase of their commerce and prosperity, and for the improvement of their health and living conditions, and the Port Authority shall be regarded as performing a governmental function in undertaking the said construction, maintenance and operation and in carrying out the provisions of law relating to the said [bridges and tunnels] and shall be required to pay no taxes or assessments upon any of the property acquired by it for the construction, operation and maintenance of such" bridges and tunnels. . . .

The respondents, during the taxable years in question, were respectively a construction engineer and two assistant general managers, employed by the Authority at annual salaries ranging between $8,000 and $15,000. All took oaths of office, although neither the compact nor the related statutes appear to have created any office to which any of the respondents were appointed, or defined their duties or prescribed that they should take an oath. The several respondents having failed to return their respective salaries as income for the taxable years in question, the commissioner determined deficiencies against them. The Board of Tax Appeals found that the Port Authority was engaged in the performance of a public function for the states of New York and New Jersey, and ruled that the compensation received by the Authority's employees was exempt from federal income tax. The Court of Appeals for the Second Circuit affirmed without opinion on the authority of *Brush v. Commissioner,* 85 F.2d 32, rev'd, 300 U.S. 352; *Commissioner v. Ten Eyck,* 76 F.2d 515, and *New York ex rel. Rogers v. Graves,* 299 U.S. 401. . . .

The Constitution contains no express limitation on the power of either a state or the national government to tax the other, or its instrumentalities. The doctrine that there is an implied limitation stems from *McCulloch v. Maryland,* 4 Wheat. 316, in which it was held that a state tax laid specifically upon the privilege of issuing bank notes, and in fact applicable alone to the notes of national banks, was invalid since it impeded the national government in the exercise of its power to establish and maintain a bank, implied as an incident to the borrowing, taxing, war and other powers specifically granted to the national government by Article I, Section 8 of the Constitution. It was held that Congress, having power to establish a bank by laws which, when enacted under the Constitution, are supreme, also had power to protect the bank by striking down state action impeding its operations; and it was thought that the state tax in question was so inconsistent with Congress's constitutional action in establishing the bank as to compel the conclusion that Congress intended to forbid ap-

plication of the tax to the federal bank notes. *Cf. Osborn v. Bank of the United States*, 9 Wheat. 738, 865–868.

In sustaining the immunity from state taxation, the opinion of the Court, by Chief Justice Marshall, recognized a clear distinction between the extent of the power of a state to tax national banks and that of the national government to tax state instrumentalities. He was careful to point out not only that the taxing power of the national government is supreme, by reason of the constitutional grant, but that in laying a federal tax on federal instrumentalities the people of the states, acting through their representatives, are laying a tax on their own institutions and consequently are subject to political restraints which can be counted on to prevent abuse. State taxation of national instrumentalities is subject to no such restraint, for the people outside the state have no representatives who participate in the legislation; and in a real sense, as to them, the taxation is without representation. The exercise of the national taxing power is thus subject to a safeguard which does not operate when a state undertakes to tax a national instrumentality.

It was perhaps enough to have supported the conclusion that the tax was invalid, that it was aimed specifically at national banks and thus operated to discriminate against the exercise by the Congress of a national power. Such discrimination was later recognized to be in itself a sufficient ground for holding invalid any form of state taxation adversely affecting the use or enjoyment of federal instrumentalities. *Miller v. Milwaukee*, 272 U.S. 713; *Cf. The Pacific Co., Ltd. v. Johnson*, 285 U.S. 480, 493. But later cases have declared that federal instrumentalities are similarly immune from non-discriminatory state taxation—from the taxation of obligations of the United States as an interference with the borrowing power, *Weston v. Charleston*, 2 Pet. 449; and from a tax on "offices" levied upon the office of a captain of a revenue cutter. *Dobbins v. Erie County*, 16 Pet. 435.

That the taxing power of the federal government is nevertheless subject to an implied restriction when applied to state instrumentalities was first decided in *Collector v. Day*, 11 Wall. 113, where the salary of a state officer, a probate judge, was held to be immune from federal income tax. The question there presented to the Court was not one of interference with a granted power in a field in which the federal government is supreme, but a limitation by implication upon the granted federal power to tax. In recognizing that implication for the first time, the Court was concerned with the continued existence of the states as governmental entities, and their preservation from destruction by the national taxing power. The immunity which it implied was sustained only because it was one deemed necessary to protect the states

from destruction by the federal taxation of those governmental functions which they were exercising when the Constitution was adopted and which were essential to their continued existence.

. . .

In tacit recognition of the limitation which the very nature of our federal system imposes on state immunity from taxation in order to avoid an ever expanding encroachment upon the federal taxing power, this Court has refused to enlarge the immunity substantially beyond those limits marked out in *Collector v. Day, supra.* It has been sustained where, as in *Collector v. Day*, the function involved was one thought to be essential to the maintenance of a state government: as where the attempt was to tax income received from the investments of a municipal subdivision of a state, *United States v. Railroad Co.*, 17 Wall. 322; to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power of the state, *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429; *cf. Weston v. Charleston, supra*, pp. 465–466; or to tax the manufacture and sale to a municipal corporation of equipment for its police force, *Indian Motocycle Co. v. United States*, 283 U.S. 570.

But the Court has refused to extend the immunity to a state conducted liquor business, *South Carolina v. United States, supra; Ohio v. Helvering*, 292 U.S. 360, or to a street railway business taken over and operated by state officers as a means of effecting a local public policy. *Helvering v. Powers*, 293 U.S. 214. It has sustained the imposition of a federal excise tax laid on the privilege of exercising corporate franchises granted by a state to public service companies. *Flint v. Stone Tracy Co.*, 220 U.S. 107, 157. In each of these cases it was pointed out that the state function affected was one which could be carried on by private enterprise, and that therefore it was not one without which a state could not continue to exist as a governmental entity. The immunity has been still more narrowly restricted in those cases where some part of the burden of a tax, collected not from a state treasury but from individual taxpayers, is said to be passed on to the state. In these cases the function has been either held or assumed to be of such a character that its performance by the state is immune from direct federal interference; yet the individuals who personally derive profit or compensation from their employment in carrying out the function were deemed to be subject to federal income tax.

In a period marked by a constant expansion of government activities and the steady multiplication of the complexities of taxing systems, it is perhaps too much to expect that the judicial pronouncements marking the boundaries of state immunity should present a completely logical pattern. But they disclose no purposeful departure from, and indeed definitely establish, two

guiding principles of limitation for holding the tax immunity of state instrumentalities to its proper function. The one, dependent upon the nature of the function being performed by the state or in its behalf, excludes from the immunity activities thought not to be essential to the preservation of state governments even though the tax be collected from the state treasury. . . . The other principle, exemplified by those cases where the tax laid upon individuals affects the state only as the burden is passed on to it by the taxpayer, forbids recognition of the immunity when the burden on the state is so speculative and uncertain that if allowed it would restrict the federal taxing power without affording any corresponding tangible protection to the state government; even though the function be thought important enough to demand immunity from a tax upon the state itself, it is not necessarily protected from a tax which well may be substantially or entirely absorbed by private persons. *Metcalf & Eddy v. Mitchell, supra; Willcuts v. Bunn,* 282 U.S. 216.

With these controlling principles in mind we turn to their application in the circumstances of the present case. The challenged taxes laid under section 22, Revenue Act of 1932, c. 209, 47 Stat. 169, 178, are upon the net income of respondents, derived from their employment in common occupations not shown to be different in their methods or duties from those of similar employees in private industry. The taxpayers enjoy the benefits and protection of the laws of the United States. They are under a duty to support its government and are not beyond the reach of its taxing power. A non-discriminatory tax laid on their net income, in common with that of all other members of the community, could by no reasonable probability be considered to preclude the performance of the function which New York and New Jersey have undertaken, or to obstruct it more than like private enterprises are obstructed by our taxing system. Even though, to some unascertainable extent, the tax deprives the states of the advantage of paying less than the standard rate for the services which they engage, it does not curtail any of those functions which have been thought hitherto to be essential to their continued existence as states. At most it may be said to increase somewhat the cost of the state governments because, in an interdependent economic society, the taxation of income tends to raise (to some extent which economists are not able to measure, see *Indian Motocycle Co. v. United States, supra,* p. 581, footnote 1) the price of labor and materials. The effect of the immunity if allowed would be to relieve respondents of their duty of financial support to the national government, in order to secure to the state a theoretical advantage so speculative in its character and measurement as to be unsubstantial. A tax immunity devised for protection of the states as governmental entities cannot be pressed so far. . . .

As was pointed out in *Metcalf & Eddy v. Mitchell, supra,* p. 524, there may be state agencies of such a character and so intimately associated with the performance of an indispensable function of state government that any taxation of it would threaten such interference with the functions of government itself as to be considered beyond the reach of the federal taxing power. If the tax considered in *Collector v. Day, supra,* upon the salary of an officer engaged in the performance of an indispensable function of the state which cannot be delegated to private individuals, may be regarded as such an instance, that is not the case presented here.

Expressing no opinion whether a federal tax may be imposed upon the Port Authority itself with respect to its receipt of income or its other activities, we decide only that the present tax neither precludes nor threatens unreasonably to obstruct any function essential to the continued existence of the state government. So much of the burden of the tax laid upon respondents' income as may reach the state is but a necessary incident to the co-existence within the same organized government of the two taxing sovereigns, and hence is a burden the existence of which the Constitution presupposes. The immunity, if allowed, would impose to an inadmissible extent a restriction upon the taxing power which the Constitution has granted to the federal government.

Reversed.

[The concurring opinion of MR. JUSTICE BLACK, and the dissenting opinion of MR. JUSTICE BUTLER, in which MR. JUSTICE McREYNOLDS concurred, are omitted.]

Notes

Following this decision, the Department of Justice published an elaborate study entitled Taxation of Government Bondholders and Employees, The Immunity Rule and the Sixteenth Amendment (1938); a few sets of a five volume Appendix, giving the full text of documents, articles, newspaper reports, and so on, were made available, and may be found, among other places, in the Harvard and Columbia Law Libraries. There was also an answering brief, The Constitutional Immunity of State and Municipal Securities, filed by the Attorneys General of the States.

The *Gerhardt* decision led to the enactment of the Public Salary Tax Act of 1939, which has removed the minor but insidious sore of tax immune salaries.[1]

The major problem of tax exempt securities still remains. Under the Public Debt Act of 1941, the interest on all federal securities issued since March 1, 1941, has been subject to federal income tax. But sec. 103 of the 1954 Code gives a statutory exemption from federal tax to interest on state and municipal bonds. Because of this statutory exemption, it has been held

[1] See Shaw, "Public Salary Tax Act of 1939," 27 Calif.L.Rev. 705 (1939).

that interest on bonds of the Port of New York Authority is not taxable. *Commissioner v. Shamberg's Estate,* 144 F.2d 998 (C.C.A.2d, 1944), cert. den., 323 U.S. 792 (1945). See also *Commissioner v. White's Estate,* 144 F.2d 1019 (C.C.A.2d, 1944), cert. den., 323 U.S. 792 (1945), involving bonds of the Triborough Bridge Authority. As long as the statutory exemption remains, the constitutional question is never reached. And while the constitutional doubt remains, it is difficult to get the statute changed. The federal income tax cannot be fair and adequate in the application of its progressive rates until this hole is in some way filled. In 1942, the Treasury tried very hard to get the tax exemption of state and municipal bond interest removed. See statement of Secretary Morgenthau, in Hearings of 1942, p. 8. But the Treasury sought to have the exemption removed even as to bonds already issued. This was too much for Congress to swallow, and the golden opportunity was missed.[2]

In 1951, the Treasury again urged that the statutory exemption be removed. This time it limited its proposal to interest on future issues. Again it was unsuccessful. See Hearings Before the Committee on Ways and Means, Revenue Revision of 1951, vol. 2, pp. 903–1159.

Would a statute now passed taxing the income of state and municipal bonds hereafter issued be constitutional? *Cf. State of New York v. United States,* 326 U.S. 572 (1946). These questions are extensively reviewed in Powell, "The Waning of Intergovernmental Tax Immunities," 58 Harv.L.Rev. 633 (1945); Powell, "The Remnant of Intergovernmental Tax Immunities," 58 Harv.L.Rev. 757 (1945).

Suppose a public facility is built, such as a toll road, tunnel, or bridge, and bonds are issued with the interest and principal payable only from the receipts from the facility, that is, the tolls, without any general pledge of public liability. Is the interest exempt from Federal tax? See Ratchford, "Revenue Bonds and Tax Immunity," 7 Nat.Tax J. 40 (1954). See also Lent, "The Origin and Survival of Tax Exempt Securities," 12 Nat.Tax J. 301 (1959).

The general problem of the interrelationship of federal and state taxes, and taxing powers, is surveyed in Federal, State, and Local Government Fiscal Relations (1943), a Report submitted to the Secretary of the Treasury by a special committee designated to conduct a study of intergovernmental fiscal relations.

[2] In addition to the material referred to in the first paragraph of this Note, see Gelfand, "Tax Exempt Securities and the Doctrine of Reciprocal Immunities," 32 Temple L.Q. 173 (1959); Ratchford, "Intergovernmental Tax Immunities in the United States," 6 Nat.Tax J. 305 (1953). For earlier discussions, see Rottschaefer, "Federal Taxation of State and Municipal Bond Interest," 20 N.C.L.Rev. 141 (1942); Gray, "Derivative Tax Immunity and the Income from State Bonds," 41 Col.L.Rev. 1357 (1941); Bronfenbrenner, "Economic Effects of the Taxation of Government Securities," 35 Ill.L.Rev. 293 (1940); Lowndes, "Taxing the Income from Tax Exempt Securities," 32 Ill.L.Rev. 643 (1938); Brown, "Intergovernmental Tax Immunity: Do We Need a Constitutional Amendment?" 25 Wash.U.L.Rev. 153 (1940).

See also Browne, "Federal-State Coordination," 21 Corn.L.Q. 182 (1945); Maxwell, "The Report of the Commission on Intergovernmental Relations," 9 Nat.Tax J. 55 (1956).

REVENUE RULING 54-296

Internal Revenue Service, 1954. 1954-2 Cum.Bull. 59.

Advice is requested regarding the treatment, for Federal income tax purposes of (1) a nonprofit corporation to be formed under the general corporation laws of the State for the purpose of converting certain municipally owned property to community use and (2) interest on the debenture notes to be issued by the corporation for the purpose of financing such improvements.

A group of public spirited citizens feel that the city of M has pressing need of a structure suitable for general purposes, civic and recreational use such as sporting events, various school functions and other municipal enterprises. Efforts have been made to get the city to convert certain of its municipally owned property into such a structure. However, due to many other demands for expenditures by the city for capital improvements of a very pressing nature, the city council has been reluctant to appropriate funds to effect such conversion.

It is proposed that a nonprofit corporation be formed to effect the desired improvements to the municipally owned property and that all of the capital stock of the corporation be issued to the city of M in exchange for a lease on the property, the lease to provide that at the end of its term or as soon as the indebtedness of the corporation is retired by it, or when the city assumes or discharges the outstanding debt of the corporation, whichever occurs first, the city would then become absolute owner of the improvements.

Under the plan the funds necessary to make the improvements would be borrowed on debenture notes issued by the corporation, secured by a pledge of the net revenues from the rentals of the improved property, and the debt would be liquidated from the proceeds of operations over a period approximately the length of the lease. None of the revenue will ever accrue to the benefit of any person, firm, or corporation, except the city of M, whose only direct benefit would be the value of the improvements.

On the basis of the facts present in this case, it is held that the income to be earned from the rentals of a municipally owned building by a nonprofit corporation to be formed under the general corporation laws of the State by a group of public spirited citizens to effect desired improvements to such building, and which income will never accrue to the benefit of any person, firm, or corporation except the municipality, will not be subject to Federal income tax.

Section 22(b)(4) of the Internal Revenue Code provides, in part, as follows:

> (b) EXCLUSIONS FROM GROSS INCOME—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:
>
> * * * * * * * * *
>
> (4) TAX-FREE INTERESTS.—Interest upon (a) the obligations of a State, Territory, or any political subdivision, thereof, * * *.

Accordingly, proposed debenture notes to be issued by the corporation for the purpose of financing the desired improvements will be considered as issued in behalf of the municipality which is the sole stockholder of the corporation, and the interest paid thereon will be exempt from Federal income tax under section 22(b)(4) of the Internal Revenue Code. Cf. Rev.Rul. 54–106, I.R.B.1954–12, 4.

Note

In the House version of the 1954 Code there was a provision (sec. 274) which would have disallowed the deduction of rental payments made by an industrial corporation to a State, municipality, etc., if the State had financed the purchase of the premises through the issuance of tax exempt bonds. The section was deleted by the Senate, and was not in the law as enacted. Would the provision have been constitutional? Is it the best way to handle the problem?

Judicial salaries. A small chapter in federal tax history is that involving the question whether the salaries of judges of United States courts are subject to federal tax in view of the provision of Article III, Section 1, of the Constitution that their compensation "shall not be diminished during their Continuance in Office." In *Evans v. Gore,* 253 U.S. 245 (1920), the majority of the Court decided, against a vigorous dissent, that federal judicial salaries were immune from federal tax. This conclusion was never convincing. It has now fallen, at least, in substance. In *O'Malley v. Woodrough,* 307 U.S. 277 (1939), the Court sustained a provision taxing the salaries of judges taking office after June 6, 1932. *Evans v. Gore* was not in terms overruled, but it would be a hardy judge who would rest his pocketbook on it now. Sec. 3 of the Public Salary Tax Act of 1939 amended this provision so as to apply the tax to the salaries of judges who took office before June 6, 1932. This has been sustained as to a judge who was appointed in April, 1921. *Baker v. Commissioner,* 149 F.2d 342 (C.C.A.4th, 1945).

Retroactivity. A type of constitutional problem which has constantly been presented in tax cases is that of retroactivity. No federal income tax has ever been held invalid on the ground that it was retroactive. Retroactivity in an income tax was sustained in *Stockdale v. Insurance Companies,* 20 Wall. 323 (1873).

The 1913 income tax was upheld in the *Brushaber* case as applied to income arising after March 1, 1913, although the statute was enacted on October 3, 1913. The Revenue Act of 1918, applicable to income for the calendar year 1918, was not enacted until February 24, 1919. In *Welch v. Henry,* 305 U.S. 134 (1938), the Court upheld a Wisconsin income tax enacted in March, 1935, and applicable to dividends received in 1933.[3]

It would hardly be accurate to say that there are no questions of retroactivity in federal income taxation. They will be seen lurking occasionally in the cases which follow. For an exhaustive review, see Novick and Petersberger, "Retroactivity in Federal Taxation," 37 Taxes 407, 499 (1959). But it is clear that considerations of retroactivity have played a very minor part in income tax cases compared to the importance which has been given to them in the estate and gift tax field. Is there any reason for this distinction?

Economic, Political and Social Problems

Law and economics are not unrelated categories, and this is particularly evident in a field like taxation. The fact that economic and social problems can only be suggested in this book does not mean that they are not important to the tax student, and even to the tax practitioner who does not purport to be a student. For often it is important to the tax practitioner to know how the tax law is likely to change, and economic and political and social considerations will certainly enter into any such forecast.

With particular regard to the income tax, reference may be made to the matter of tax rates. Individual income tax rates have recently been as high as ninety per cent; the fifty per cent bracket is reached with incomes of $16,000. How far do such tax rates discourage business initiative? How far are men of means faced with such a tax on their gains induced to say "To hell with it," put their money into tax exempt securities and loll on the sand in Florida—instead of risking their means on productive enterprise?[1] How far would the Government actually raise more revenue from lower tax rates if they would encourage a greater volume of business enterprise? How far would a reduction of tax rates on high incomes be politically feasible? Is there any other way that the problem can be dealt with, as by allowing a deduction or credit for property invested in productive enterprise?[2]

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[3] But see People ex rel. Beck v. Graves, 280 N.Y. 405, 21 N.E.2d 371 (1939), where the court held that retroactivity of sixteen years was too much.

[1] See Break, "Income Taxes and Incentives to Work: An Empirical Study," 47 Am.Econ.Rev. 529 (1957). *Cf.* Herzfelder, "Does 20 x $50,000 = $67,000?" 17 Taxes 21 (1939). See Magee, "The Proposal to Reduce High Surtaxes—The Case for Reduction," 7 Law and Contemporary Problems 183 (1940); Groves, "The Case Against Reduction," *ibid.* 189.

[2] See, generally, Butters, "Taxation, Incentives, and Financial Capacity," 44 Am.Econ.Rev. 504 (1954); Lintner, "Effect of Corporate Taxation on Real Investment," 44 Am.Econ.Rev. 520 (1954); Kimmel, Taxes and Economic Incentives (1950).

Questions such as these cannot be answered dogmatically. Indeed there are very few data available for answering them on any basis other than that of trial and error or hunch. One of the early efforts to investigate problems of this sort with respect to the general tax system appears in a volume sponsored by the Twentieth Century Fund entitled Facing the Tax Problem, A Survey of Taxation in the United States and a Program for the Future (1937). The Twentieth Century Fund also published at the same time a volume called Studies in Current Tax Problems, which contains some of the research memoranda that were developed in the course of assembling material for the first volume.[3]

Particular attention has been given to the effect of corporate taxes on the development of new enterprises.[4] How far are taxes useful and desirable as a means of general economic control, such as to prevent inflation? [5] During the war the Treasury proposed a "Spendings Tax," that is, a tax on income spent, rather than on income received. Under such a tax amounts received, but saved would not have been subjected to taxation. Would such a tax be desirable in wartime, or in peacetime? [6] It has recently been argued that available income may actually be increased through taxation.[7] It is also suggested that our tax laws are responsible for the existence of slums in our cities.[8]

How far should small incomes be taxed? See Strayer, The Taxation of Small Incomes (1939).[9] Effective means of taxing

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3 See also Strayer, "The Effect of A Rise in Prices Upon the Income Tax," 24 Bull.Nat.Tax Assn. 165 (1939); Altman, "Control of the Business Cycle by Means of the Income Tax," 13 Tax.Mag. 9 (1935); Colm and Lehman, Economic Consequences of Recent American Tax Policy (1938); Studenski, "Economic Effects of New Deal Fiscal Policies," 19 Taxes 14 (1941).

4 See, generally, Butters and Lintner, Effect of Federal Taxes on Growing Enterprises (1945); Domar and Musgrave, "Proportional Income Taxation and Risk-Taking," 58 Q.J.Econ. 388 (1944); Abbott, "Venture Capital and Taxation," 54 Q.J.Econ. 667 (1941); Bradley, "Direct Effects of a Corporate Income Tax," 56 Q.J.Econ. 638 (1942); O'Neil, "Do High Corporate Taxes Deter Investment?" 22 Harv.Bus.Rev. 443 (1944); Wallich, "Effect of Taxation on Investment," 23 Harv.Bus.Rev. 442 (1945); Butters, "Taxation and New Product Development," 23 Harv.Bus.Rev. 451 (1945).

See also Smith and Mace, "Tax Uncertainties in Corporate Financing," 20 Harv.Bus.Rev. 315 (1942); May, "Corporate Structures and Federal Income Taxation," 22 Harv.Bus.Rev. 10 (1943); Ballantine, "The Corporation and the Income Tax," 22 Harv.Bus.Rev. 277 (1944); Clendenin, "Effect of Corporate Income Taxes on Corporate Earnings," 34 Taxes 391 (1956); Brudno, "The Effects of Taxes on Business Policies and Practices in Great Britain," 13 Journal of Finance 211 (1958).

5 See Shoup, Friedman, and Mack, Taxing to Prevent Inflation (1943); Hart, "Use of Flexible Taxes to Combat Inflation," 32 Am.Econ.Rev. 87 (1942).

6 See Vickrey, "The Spending Tax in Peace and War," 43 Col.L.Rev. 165 (1943); Friedman, "The Spending Tax as a Wartime Fiscal Measure," 33 Am.Econ.Rev. 50 (1943); Poole, "Problems of Administration and Equity Under a Spending Tax," 33 Am.Econ.Rev. 63 (1943).

7 See Hubbard, Creation of Income by Taxation (1950).

8 See Sporn, "Some Contributions of the Income Tax Law to the Growth and Prevalence of Slums," 59 Col.L.Rev. 1026 (1959).

9 See also Pettengill, "Tax Burden Among Income Groups," 30 Am.Econ. Rev. 60 (1940); Tucker, "The Distribution of Income Among Income Tax-

small incomes was first made available by the withholding at the source provisions of the Current Tax Payment Act of 1943. Should taxes on small incomes now be reduced or eliminated? Who does bear the economic burden of federal taxes? [10]

There have in recent years been two comprehensive studies of basic tax policy under the auspices of Congressional Committees. The first of these is contained in Hearings before the Joint Committee on the Economic Report, Subcommittee on Tax Policy, in 1955. These Hearings were published under the title "Federal Tax Policy for Economic Growth and Stability," 84th Congress, 1st Session (1955). Following the Hearings, the Committee published its Report. Senate Report No. 1310, 84th Congress, 2nd Session (1956). Note the following comment on this Report in Rudick and Wender, "Federal Income Taxation," in the 1956 Annual Survey of American Law, 32 N.Y.U.L.Rev. 751, 752 (1957): "There was general agreement among the expert witnesses and on the Committee that the present structure is not sufficiently progressive in fact. At the same time, it was also recognized that the top income tax rates are too high. This seeming paradox is easily explained. The rate structure has been kept at an unconscionably high level. Rather than attacking this inequity directly, Congress has chosen for political reasons to alleviate the rates by allowing loopholes to develop. Some examples are tax-free interest on state and municipal bonds, percentage depletion allowances, and the broad definition of capital gains. These loopholes are available chiefly to those in high tax brackets. Thus, the actual burden of taxation on wealthy taxpayers often is hardly greater than on taxpayers of modest circumstances. If the alleviation of high tax rates by 'gimmicks' provided equivalent relief to all taxpayers with the same economic income, it might be acceptable. However, our present structure tends heavily to penalize those whose income is earned by personal services since relief is extended almost exclusively to those whose income is derived from capital. It is to be hoped that the attention given this problem by the Joint Committee on the Economic Report may in time result in correction of these inequities."

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payers in the United States, 1863–1935," 52 Q.J.Econ. 547 (1938); Strangman, "Taxation of 'Lower Bracket' Incomes," 14 Tax.Mag. 331 (1936); Strayer, "The Proposal to Tax Small Incomes," 7 Law and Contemporary Problems 171 (1940).

10 See Bodenhorn, "The Shifting of the Corporation Income Tax in a Growing Economy," 70 Q.J.Econ. 563 (1956); Brannon, "The Incidence of the Corporate Income Tax," 11 Tax Exec. 314 (1959); Tarasov, Who Does Pay the Taxes? (1942); Oakes, "The Incidence of the General Income Tax," 32 Am. Econ.Rev. (Supp.) 76 (1942); Holden, "Incidence of Taxation," 30 Am.Econ. Rev. 774 (1940); Weston, "Incidence and Effects of the Corporate Income Tax," 2 Nat.Tax J. 300 (1949). See also Shultz, "Economic Effects of a Federal General Sales Tax," 21 Taxes 419 (1943).

The most recent study was under the auspices of the Committee on Ways and Means of the House of Representatives in 1959. The papers submitted to the Committee were published in three volumes as Tax Revision Compendium—Compendium of Papers on Broadening the Tax Base (1959).

A thorough discussion of the problems of progessive taxation will be found in Blum and Kelven, "The Uneasy Case for Progressive Taxation," 19 U. of Chi.L.Rev. 417 (1952), also published separately as a book. See also Groves, "Toward a Social Theory of Progressive Taxation," 9 Nat.Tax J. 27 (1956); Morag, "Reflections on Progressive Taxation," 11 Nat.Tax J. 219 (1958).

Many provisions make their way into the tax statute because of special interests and pressures. For a thoughtful consideration of the underlying problem, see Surrey, "The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted," 70 Harv.L.Rev. 1145 (1957).

The student will find that the income tax statute is a very complicated document. In going through the material which follows, consideration may well be given to the question whether the statute could be simplified, and if so whether a particular simplification would really be desirable. See Eichholz, "Should the Federal Income Tax Be Simplified?" 48 Yale L.J. 1200 (1939); Blum, "Simplification of the Federal Income Tax Law," 10 Tax L.Rev. 239 (1955).[11] How far is specification useful, and what are the dangers of over specification? Cf. Angell, "Tax Evasion and Tax Avoidance," 38 Col.L.Rev. 80 (1938).[12]

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11 Compare these conclusions of two legislative committees: "We have formed the opinion that in Income Tax matters simplicity is not the sole object to be aimed at, and that the price that would have to be paid for a simple Income Tax could not be justified." Report of the Royal Commission on the Income Tax, Cmd. 615, p. 140 (1920). "It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not." 1 Report of the Joint Committee on Internal Revenue Taxation 5 (1928).

12 See also Paul, "Simplification of Federal Tax Laws," 20 Corn.L.Q. 285 (1944); Altman, "Simplication of the Income Tax," 22 Taxes 146 (1944); Ellis, "What is Wrong with the Federal Tax System," 78 J. of Accountancy 381 (1944).

Some simplification for persons of small and moderate incomes was achieved by the Individual Income Tax Act of 1944, which added the optional tax provision now found in sec. 3 of the 1954 Code, and the optional standard deduction in sec. 141. This also added the provision found in sec. 6014 of the new Code which makes it possible for wage earners to use a simplified return on which the District Director computes the amount of any tax remaining due or any refund to be paid.

The Current Tax Payment Act of 1943 enacting the provision now found in sec. 3401 *et seq.* of the 1954 Code, was the first major provision for collection of tax at the source from wage earners.[13] This statute also added the provisions now found in secs. 6015, 6073 and 6153 of the new Code, which provide for the filing of estimated returns, and the payment quarterly of an estimated tax by those whose tax is not covered by withholding. Whether this particular provision has resulted in any simplification is a question. The change from payment of the tax on one year's income during the following year to payment currently of the tax on the current year's income raised the controversy about forgiveness, which was compromised in sec. 6 of the Current Tax Payment Act of 1943. Under this taxpayers were forgiven three quarters of the tax on income for 1942 or 1943, whichever was smaller. Thus the Government increased its war time receipts by the unforgiven 25%; otherwise taxpayers continued to pay about the same amount each year; and the overall tax burden was shifted slightly.

Section 6016, which was first enacted in the 1954 Code, requires corporations to file an estimated tax return if they expect their income tax to be more than $100,000. Corporations have also been put on a "pay as you go" plan. See section 6154. None of their tax was forgiven; instead they paid an increasing percentage of the current year's tax each year for 5 years, and now pay one-half of the tax in the year of receipt, and the other half by June 15 of the following year.

Normal Tax and Surtax

From the beginning, the income tax has had a concept of normal tax and of surtax. At the start, the normal tax, at a fixed rate, was applied to all income, whether received by corporations or by individuals. Then, there was a surtax, at graduated rates which was payable by individuals on their income in excess of a stated amount. When an individual received a dividend, it was subject only to the surtax, since the theory was that the normal tax had already been paid by the corporation.

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13 See "Personal Liability of Corporate Officers for Unpaid Withheld or Collected Taxes," 12 Tax L.Rev. 343 (1957).

The normal tax also became relevant because certain federal securities were issued on which the interest was exempt from normal tax, but subject to surtax. Some of these securities are still outstanding.

Over the years, the simple scheme of the original tax gave way to various pressures. The normal tax rate increased. In 1934 the exemption of dividends from normal tax was terminated. Largely because of the continued existence of partially-exempt securities, the imposition of both a normal tax and a surtax persisted in the tax laws.

In the Internal Revenue Code of 1954, the two taxes are combined, as far as individuals are concerned. The old distinction is recognized by sec. 1(c) which specifies that the tax imposed by sec. 1 consists of a normal tax of 3% and a surtax equal to the balance of the aggregate tax. In the case of corporations, the normal tax and the surtax remain separate. Sec. 11. The distinction between normal tax and surtax becomes important for a number of purposes in connection with corporations. For example, only the normal tax applies to the first $25,000 of the income of a corporation.

Exempt Organizations

Congress has determined that private financing of religious, charitable, and educational activities is to be encouraged. This explains the deduction provided in sec. 170 for private gifts to charity. It also explains exempting organizations engaged in such activities from the federal income tax. Section 501(c) contains a rather extensive list of these organizations, its most important and most inclusive provision being paragraph 3 which exempts organizations "operated exclusively for religious, charitable, scientific, literary, or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation." Some difficult problems have arisen in interpreting the statutory standards.[1]

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[1] For discussions of the problems under the earlier law, see Latcham, "Private Charitable Foundations: Some Tax and Policy Implications," 98 U. of Pa.L.Rev. 617 (1950); Eaton, "Charitable Foundations, Tax Avoidance and Business Expediency," 35 Va.L.Rev. 809, 987 (1949); "The Modern Philanthropic Foundation; A Critique and a Proposal," 59 Yale L.J. 477 (1950). See also "Educational Institutions in Section 101(6)," 36 Va.L.Rev. 519 (1950); Cary, "Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax and Policy Considerations," 62 Harv.L.Rev. 1 (1948); "The Use of Charitable Foundations for Avoidance of Taxes," 34 Va.L.Rev. 182 (1948).

Notes

(A) *Cf. Industrial Addition Ass'n v. Commissioner,* 149 F.2d 294 (C.C.A.6th, 1945), where the taxpayer corporation was organized for the purpose of inducing industry to move to a town in order to relieve an unemployment problem there. It borrowed money to buy land, giving certificates of ownership as security, and it later rented the land to a mill at a rental which was fixed at an amount necessary to pay 6% interest on the money borrowed. The court held that the Association was not operated exclusively for the promotion of social welfare, and that its income was subject to taxation, even though the Association was a non-profit corporation under Tennessee law, and its charter prohibited it from distributing dividends.

(B) *Universal Oil Products Co. v. Campbell,* 181 F.2d 451 (C.A.7th, 1950), cert. den. 340 U.S. 850 (1950), involved a company originally organized by a number of oil companies for the purpose of conducting research and holding patents. In connection with the settlement of an anti-trust case, the several owners of the company transferred all of their stock in it to a Foundation the income of which was to be used for the promotion of research and the enlargement of knowledge with respect to oil and the oil industry. It was held that the income of the company was not exempt from Federal taxation. But *cf. Commissioner v. Orton,* 173 F.2d 483 (C.A.6th, 1949), where the Edward J. Orton, Jr., Ceramic Foundation, established by a will for research in ceramics was held exempt.

See Finkelstein, "Freedom from Uncertainty in Income Tax Exemptions," 48 Mich.L.Rev. 449 (1950).

Organizations which clearly meet the statutory requirement for tax exemption have frequently entered into profit producing enterprises, applying the profits so realized to the charitable purposes of the organization. Section 512, which taxes unrelated business income, was added as a result of such cases as *C. F. Mueller Co. v. Commissioner,* 190 F.2d 120 (C.A.3d, 1951) where the Commissioner sought unsuccessfully to tax the profits accruing to New York University through the operation of a macaroni factory. The income from such operations is now taxed. Secs. 511–514 of the 1954 Code, first enacted in 1950. But the dividends or interest paid by the manufacturing corporation to the exempt organization is still tax free, as are such receipts from any other source. For discussion, see Sugarman and Pomeroy, "Business Income of Exempt Organizations," 46 Va.L.Rev. 424 (1960).

The provisions are elaborate and complex. They deal not merely with "unrelated business income" but also with income derived by a charity through a so-called sale and lease-back arrangement where the purchase price is paid with borrowed

money, or where the charity assumes indebtedness in connection with the arrangement. Section 514 taxes the charity, but the seller-lessee may also lose some of its deductions. See *Century Electric Co. v. Commissioner,* 192 F.2d 155 (C.A.8th, 1951), *infra,* p. 638.

The statute also sets out certain transactions which, if entered into, will result in the loss of the charity's exemption. See section 503. And under section 504 a charitable organization will lose its tax exemption if it accumulates its income (instead of paying it out) in such amounts "as are unreasonable in amount or duration in order to carry out its charitable purpose," or are used in a way which is inconsistent with the basic charitable purposes of the enterprise. This provision is somewhat analogous to the special tax imposed on corporations which unreasonably accumulate their profits, imposed by sections 531–536 of the Code. It seems very likely that it will work out as a reasonably sound and satisfactory solution for a very difficult problem. The difficulties which surround sections 531–536 will probably not be encountered with respect to accumulations by charitable organizations. It should ordinarily be possible to tell with little difficulty whether a particular charity's accumulation is legitimate or not.

By sections 6033(b), 6035 and 6104 of the 1954 Code, originally added in 1950, certain tax exempt organizations are required to file returns giving information about their activities, and this information is to be made public.[1]

Notes

Recent cases involving the question of the taxability of charitable enterprises include the following:

Randall Foundation, Inc. v. Riddell, 244 F.2d 803 (C.A. 9th, 1957). Here it appeared that the Foundation was organized as a nonprofit corporation in California. It received contributions

[1] On these changes generally, see Eaton, "Charitable Foundations and Related Matters under the 1950 Revenue Act," 37 Va.L.Rev. 1 (1951); Latcham, "Charitable Organizations and Federal Taxation," 3 West.Res.L.Rev. 99 (1951); Brown, "The New Restrictions on Charitable Exemptions and Deductions for Federal Tax Purposes," 13 U. of Pitt.L.Rev. 623 (1952); Morgan, "Present Status of 'Exempt' Corporations," 31 Taxes 296 (1953); Myers, "Taxing the Colleges," 38 Corn.L.Q. 368 (1953); Rea, "Changes in the Internal Revenue Code of 1954 Affecting Charitable Organizations," 27 Rocky Mountain L. Rev. 270 (1955); Sugarman, "Current Issues in the Use of Tax-Exempt Organizations," 34 Taxes 795 (1956); McGregor, "Tax Treatment of Charities in the United Kingdom, Canada and the United States," 4 Can.Tax J. 188 (1956); Moore and Dohan, "Sales, Churches, and Monkeyshines," 11 Tax L.Rev. 87 (1956); "Income Tax Disadvantages of Political Activity," 57 Col.L.Rev. 273 (1957); Grant, "Taxation of Exempt Charitable Organizations Engaging in Business Activities," 4 U.C.L.A.L.Rev. 352 (1957); Reiling, "What is a Charitable Organization?" 44 A.B.A.J. 525 (1958); Myers and Quiggle, "Alumni Association as Organizations Described in Section 501(c)(3) of the Code," 45 A.B.A.J. 392 (1959).

of shares of stock from one person who also loaned it substantial sums of money, charging interest at 2½%. The Foundation traded in securities, and made a substantial net profit. Practically all of the sales were short term transactions. At the close of its first fiscal year, it made a donation of $500 to a charitable organization. The court held that this was a business, and not a charitable activity, and that it was not exempt from income tax.

Boman v. Commissioner, 240 F.2d 767 (C.A. 8th, 1957). The taxpayer, a physician, made a gift to Duluth Clinic Foundation. He was a member of the Duluth Clinic, a partnership of physicians. The Foundation was organized in 1945. The Clinic then transferred by gift all its furniture, fixtures, and tangible personal property to the Foundation. The Foundation then leased the property to the Clinic. The Foundation also acquired the building housing the Clinic, and leased the space to the Clinic. It did not appear that any charitable contributions had actually been made by the Foundation, but it was provided that on dissolution of the Foundation all of its assets should be used for medical education or research, or be given to the University of Minnesota for its College of Medicine.

The court held that the Foundation was charitable, and that the gift to it was deductible. It held that the Foundation was organized and operated exclusively for charitable purposes, the test being disposition rather than source of its income.

The two cases would not appear to be basically consistent.

Mutual Savings Banks. Section 593 of the 1954 Code makes mutual savings banks, building and loan associations, and cooperative banks subject to the regular corporate income tax whenever their accumulated surplus is in excess of 12% of deposits. In other words, they are allowed to accumulate earnings tax free until they have built up a surplus of 12% of their deposits.

Note

These banks are of course entitled to deduct in full the amount of interest paid or credited to their depositors. Note that the new tax amounts in substance to something very close to an undistributed profits tax. Such banks can entirely eliminate any federal tax liability by distributing all of their earnings to their depositors whenever their surplus exceeds 12% of deposits. What is the effect of this likely to be? Will such banks be able to tell their depositors that they are withholding earnings to build up reserves in excess of 12% of their deposits, when 52% of the amount withheld will have to be paid to the government in tax? What will be the effect on competition among banks? What may be the effect on interest rates? Is this a desirable development?

See Lagomarcino, "The Impact of the 12% Reserve Income Tax Provision on the Banking Structure," 56 Mich.L.Rev. 401 (1958).

Problem

When an organization which has not previously been taxed is brought into taxable status, a number of problems arise. See Klarmann, "Entities not Previously Taxed," 31 Taxes 425 (1953). For example, what is the basis for depreciation of the property owned by such a taxpayer? Is it the original cost of the property, without adjustment? Or is it the cost of the property, adjusted for prior depreciation as if the entity had been taxable? Or is it the fair market value of the property at the time the entity becomes taxable. See Rev.Rul. 54–381, 1954–2 Cum.Bull. 163, holding that the basis should be cost reduced by depreciation sustained during the tax-exempt period.

Farmers' Cooperatives. Sections 521 and 522 have provisions for certain agricultural cooperatives which are taxed but get a special deduction for patronage dividends, refunds, and rebates.

See Couper, "The Farmer, the Cooperative, and the Commissioner," 7 Hastings L.J. 143 (1956). See also pages 795–797, below.

Business Income of State Colleges and Universities. Section 511(a)(2)(B) makes the income tax applicable to so-called "business income" derived by "any college or university which is an agency or instrumentality of any government or any political subdivision thereof." This puts state colleges and universities in the same position as private institutions with respect to "business income."

Problem

Is there any constitutional question about the validity of this tax? Apparently this is the first provision in the revenue laws subjecting to the income tax any income derived by a state or a state instrumentality. Cf. G.C.M. 13745, XIII–2 Cum.Bull. 76 (1934), holding that the income of a state liquor monopoly is not subject to federal income tax. Griswold, "Income Taxes of State Liquor Monopolies," 22 A.B.A.J. 619 (1936).

Non-resident Aliens and Foreign Corporations. All persons who are residents of the United States are subject to United States taxes on all their income, whether they are citizens or not. The tax on non-resident aliens is imposed by secs. 871–876 I.R.C. In general this applies only to "fixed and determinable annual or periodical" income. See *Commissioner v. Wodehouse,* 337 U.S. 369 (1949), where a lump sum advance payment for exclusive serial rights on a book was held to be subject to United States

tax. See also secs. 861–864, and secs. 1441–1451, the latter providing for withholding of the tax at source in certain cases. For discussion of some of the questions, see Weyher and Kelley, "The Income Taxation of Aliens—Some Riddles and Paradoxes," 9 Tax L.Rev. 371 (1954); Schneider, "Aliens and the United States Income Tax—1956," 34 Taxes 583 (1956); Rowen, "Tax Alternatives of a Nonresident Alien," 34 Taxes 465 (1956); Berman, "The Alien and The Federal Tax Law," 40 Marquette L. Rev. 383 (1957).[1]

The tax on foreign corporations is imposed by secs. 881–884 I.R.C. In the case of a foreign corporation doing business in the United States, gross income includes only "gross income from sources within the United States." Sec. 882(b). This term is defined in sec. 861. The questions are discussed in Allan and Coggan, "Aliens and the Federal Income Tax," 5 Tax L.Rev. 253 (1950). See also Rado, "Foreign Corporation: Its Role in the Taxation of Income from International Trade," 10 Tax L.Rev. 307 (1955).

Income from Foreign Sources. Although residents of the United States are taxable on all of their income, nonresident citizens are not taxed on their earned income from sources outside the United States. See sec. 911 I.R.C.

In the case of resident individuals or corporations doing business abroad or having income from foreign sources, there are a number of provisions of importance in determining tax liability.[2] These include the credit for taxes paid to foreign countries, or possessions of the United States, which is available against United States tax (see secs. 901–905 I.R.C.), special tax treatment for Western Hemisphere Trade Corporations (secs. 11 and 921), and treaties with a number of countries which eliminate or reduce double taxation in cases where income could be taxed by two countries. See pp. 16–17, above.[3]

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1 See also Phillips, U.S.Taxation of Foreign Entities (1952); Schneider, "Aliens and the United States Income Tax Law," 31 Taxes 795 (1953); Mayer, "Taxation of the Foreign Businessman Visiting the United States," 95 J. of Accountancy 56 (1953).

2 In Mim. 6475, 1950–1 Cum.Bull. 50, the Treasury authorized taxpayers to defer reporting income derived in foreign countries having monetary or exchange restrictions which make it difficult or impossible to transfer foreign income to the United States. This was extended to the 1954 Code in Sec. 10 of Rev.Rul. 55–171, 1955–1 Cum.Bull. 80, 88.

3 On these questions, see Cherin, "Current Tax Problems in Foreign Operations," 11 Tax Exec. 105 (1959); Brudno, "Tax Considerations in Selecting a Form of Foreign Business Organization," 13 Vanderbilt L.Rev. 151 (1959); Barlow and Wender, Foreign Investment and Taxation (1955); "Tax Incentives to Investment Abroad," 8 Stanford L.Rev. 77 (1955); Gibbons, "Tax Effects of Basing International Business Abroad," 69 Harv.L.Rev. 1206 (1956); Surrey, "Current Issues in the Taxation of Corporate Foreign Investment," 56 Col.L.Rev. 815 (1956); Newman, "Tax Administration in Striped Trousers: The International Operations Program of the Internal Revenue Service," 12 Tax L.Rev. 171 (1957); Baker and Meek, "Tax Problems of Doing Business

Abroad: Some Practical Considerations," 1957 Wis.L.Rev. 75; Hightower, "Foreign Business Income and United States Taxes," 35 Taxes 445 (1957); Magill and Schaab, "American Taxation of Income Earned Abroad," 13 Tax L.Rev. 115 (1958); Baker, "Flags of Refuge for the Shipping Industry-Federal Income Tax Consideration," 13 Tax L.Rev. 137 (1958); Cameron, "Taxes on Organizing a Business Abroad," 106 J. of Accountancy 45 (July, 1958); Pell, "Tax Aspects of Doing Business Abroad," 37 Taxes 1107 (1959); Oldman, "United States Tax Law and Treaties Affecting Private Investment," 19 Fed. B.J. 342 (1959). See also Allan and Coggan, "Tax Planning for Foreign Trade," 3 Tax L.Rev. 23 (1947); James, "Taxation of Business Income from Foreign Sources," 13 U. of Chi.L.Rev. 229 (1946); Drachsler, "Alien Law in Federal Taxation: Characterization of Alien Juristic Concepts," 33 Tulane L. Rev. 751 (1959).

CHAPTER 4

WHAT IS INCOME?

The tax is on income. How do we tell what is income and what is not? Is there any basic concept which can be defined or described? [1] The economists have devoted a great deal of thought to the definition of the concept of income, but it must be confessed that it is difficult for a lawyer to get much concrete aid from their work. Whether this is because of the deficiencies of the definitions or the inadequacies of legal training, or because of the impossibility of treating such a question by definition, may be questioned. It will be valuable to the student to compare the definitions of a few economists with the concept as it has been worked out by the courts. For that purpose, and as a reference to some of the economic literature, some of these definitions are set out below (the italics are in the originals):

R. M. Haig, "The Concept of Income," in The Federal Income Tax 1, 7 (Columbia University, 1921): "Income is the money value of the net accretion to one's economic power between two points of time."

C. C. Plehn, "Income as Recurrent, Consumable Receipts," 14 Amer.Econ.Rev. 1, 5 (1924): "Income is essentially wealth available for recurrent consumption, recurrently (or periodically) received. Its three essential characteristics are: *receipt, recurrence and expendability.*"

W. W. Hewett, The Definition of Income and its Application in Federal Taxation 22–23 (1925): *"Net individual income is the flow of commodities and services accruing to an individual through a period of time and available for disposition after deducting the necessary cost of acquisition."*

H. C. Simons, Personal Income Taxation 50 (1938): "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."

The work of a great many German, American and Italian economists is reviewed in detail in a series of articles by Wueller, "Concepts of Taxable Income," 53 Pol.Sci.Q. 83, 557 (1938), 54 *id.* 555 (1939). These contain much information and many use-

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[1] See Rottschaefer, "Concept of Income in Federal Taxes," 13 Minn.L.Rev. 637 (1929); Brown, "Nature of the Income Tax," 17 Minn.L.Rev. 127 (1933); Magill, Taxable Income, c. 12 (Rev. ed. 1945); Bailey, "Concepts of Income," 26 Harv.Bus.Rev. 680 (1948); LaBrie, The Meaning of Income in the Law of Income Tax (1953) (Canadian), reviewed in 63 Yale L.J. 1204 (1953).

ful citations. One of the author's conclusions may be regarded as encouraging for the lawyer. At 53 Pol.Sci.Q. 84, he says that his work "will certainly demonstrate that no 'general agreement' exists among economists regarding the content of 'the' concept of income." See also Tarleau, "The Concept of Income for Federal Tax Purposes," 20 Tenn.L.Rev. 568 (1949).[2]

Suppose that the economists did agree among themselves. Would this solve our problem? Are the economists and the lawyers looking for the same thing? *Cf.* Lutz, "Should Capital Gains be Taxed as Income?" 22 Bull.Nat.Tax Assn. 130 (1937): "It is possible that the gap between an acceptable income concept in the economic sense and a concept that is sufficiently practical for tax purposes can never be wholly closed."

In *Eisner v. Macomber,* 252 U.S. 189 (1920), the Supreme Court undertook a definition, which was often quoted for many years thereafter, and is still quoted, but which has, apparently, never been helpful in the decision of actual cases. The Court said (p. 207): " 'Income' may be defined as the gain derived from capital and from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets."

For an excellent discussion of the question from the legal point of view, see Surrey and Warren, "The Income Tax Project of the American Law Institute," 66 Harv.L.Rev. 761, 769–772 (1953). See also Rapp, "Some Recent Developments in the Concept of Taxable Income," 11 Tax L.Rev. 329 (1956).

Gross income is defined in **sec. 61** of the Internal Revenue Code of 1954 as "all income from whatever source derived," after which a number of items are specifically included. This section and those immediately following, through sec. 120, are the statutory provisions which are particularly involved in connection with this chapter of the casebook. (The corresponding provisions in the previous statutes were found in sec. 22(a) and (b), and these provisions are often cited in the cases which follow.)

[2] Other references include Hubbard, "Income Creation by Means of Income Taxation," 58 Q.J.Econ. 265 (1944); Fisher, "Income in Theory and Income Taxation in Practice," 5 Econometrica 1 (1937). For accounting views of the problem, see Bangs, "The Definition and Measurement of Income," 15 Accounting Rev. 353 (1940); Bowers, "Tests of Income Realization," 16 Accounting Rev. 139 (1941); Gilman, Accounting Concepts of Profit (1939); Sweeney, "Income," 8 Accounting Rev. 323 (1933).

Gross income questions may be roughly classified into three groups:

What is income?

Whose income is it?

When is it income?

These are not sharply separated; questions of the one sort shade into questions of another. The classification is, however, ordinarily a useful one, and it has been followed in this book.

In the present Chapter, cases are presented which involve what might be called the "pure question" of what is income.[1] There is no question here as to *whether* some thing or some benefit has been received, or *who* has received it, or *when* it was received. The problem is simply of *what* receipts or benefits have the quality of income.

In a rough and ready way the progression of the materials in the Chapter is from the simpler and easier questions to the more complex and difficult.

Bonuses & gratuitous payments to ~~fr~~ an employee
to the employee if the employer takes a deduct
on his return

Compensation for Services—or Gifts

Secs. 61(a)(1) and **102** of the 1954 Code

FISHER v. COMMISSIONER

Circuit Court of Appeals, Second Circuit, 1932. 59 F.2d 192.

SWAN, CIRCUIT JUDGE. The single issue presented by this appeal is whether an amount of $6,000 received by the taxpayer in 1924 from his employer was a gift, as he contends, or additional compensation for services, as the Commissioner contends. The facts were stipulated, and, without opinion, the Board found that the amount in question was compensation for services, with the result that a tax deficiency of $528.97 was adjudged.

After twenty-four years of service in the employ of Holmes Electric Protective Company, the petitioner voluntarily handed in his resignation, in December, 1924, to take effect at the end of the year. Starting as an office boy in 1900, he had risen to the position of general traffic manager, with a salary of $10,000 per year. This salary was paid him for the year 1924, and in addition he received from the company on December 23d the $6,000 herein involved. During the preceding October he had been told by his superior officer, Mr. Allen, that when he should actually leave the employ of the company "it would do something for him," but he had no intimation of what that would be until the

[1] For discussion, under the 1954 Code, see Magill and deKosmian, "Income, Deductions, Gains and Losses," 68 Harv.L.Rev. 201 (1954).

sum in question was received. Never before had his employer paid him any bonus or other addition to his regular salary, nor had there ever been any agreement that he should receive anything more than the salary which from time to time he had agreed to accept. It was not the practice of the company to pay a bonus to any of its officers or employees, nor had it ever done so. Neither in the year 1924 nor in any previous year had the petitioner performed services outside the scope of the duties of his position. The making of the $6,000 payment was not formally authorized or ratified by any vote of the executive committee or of the board of directors of the company, but it was informally approved by a majority of the members of the executive committee, one of whom was the president of the corporation which held all the stock of the Holmes Company. On the books of the latter it was charged to salary account, and was so reported on its informational tax return (form 1099), and the total sum of $16,000 was included as a deduction in the consolidated income tax return filed on behalf of the Holmes Company and the parent corporation with which it was affiliated.

Upon these facts it is urged that the $6,000 payment must necessarily have been a gift, since it was not paid pursuant to any contract obligation of the employer, nor as compensation for extra services rendered by the employee beyond the terms of his employment, nor, his resignation being voluntary, as compensation for the loss of his employment. But the mere fact that the employer was under no legal duty to pay is not conclusive that the payment was a nontaxable gift. Section 213(a) of the Revenue Act of 1924 (43 Stat. 267, 26 U.S.C.A. § 954(a)), defines gross income to include "gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid. . . ." In *Old Colony Trust Co. v. Commissioner,* 279 U.S. 716, the Supreme Court said that "the payment for services, even though entirely voluntary" may nevertheless be "compensation within the statute," citing with approval *Noel v. Parrott,* 15 F.2d 669 (C.C.A.4); and in *Lucas v. Ox Fibre Brush Co.,* 281 U.S. 115, it was held that an employer might deduct reasonable compensation voluntarily paid to employees for services rendered in prior years. The doctrine that bonus payments and gratuitous "additional compensation" for past services may constitute taxable income has been frequently recognized in decisions of the lower federal courts and of the Board of Tax Appeals. See *Noel v. Parrott, supra;* . . . Whether a payment in a given case shall be deemed taxable compensation or a gift exempt from tax depends upon the intention of the parties, and particularly that of the employer, to be determined from the facts and circumstances surrounding the transaction. In the case at bar, the Holmes

Company clearly indicated its intention by charging the payment upon its books to salary account and so reporting it in its tax returns. It is urged that these were the acts of subordinate officials not shown to have been authorized to so treat the payment, but surely the burden of proving their lack of authority, if such was the fact, was upon the taxpayer. Nor is there merit in the petitioner's contention that the sole stockholder approved the payment and hence presumptively intended to make a gift rather than to pay additional compensation. There was no action by the corporate stockholder; its president would have no authority by virtue of his office to give away its property. On the record presented, the Board's finding that the payment was additional compensation was amply justified.

Order affirmed.

Notes

(A) Tips are taxable as income. See sec. 1.61–2(a) of the Income Tax Regulations. In *Nazzareno D. Cesanelli,* 8 T.C. 776 (1947), tips received by waiters were held to be income, and fraud penalties for failing to report them were sustained. But tips are not subject to withholding under the provisions of the law with respect to collection of the tax at the source, nor are they self-employment income. Rev.Rul. 57–71, 1957–1 Cum.Bull. 277.

(B) In *United States v. McCormick,* 67 F.2d 867 (C.C.A.2d, 1933), cert. den. 291 U.S. 662 (1934), the defendant had been indicted (under a provision corresponding to sec. 7201 of the 1954 Code) for willfully failing to file a tax return. He was a deputy city clerk for the city of New York. Among other facts shown, it appeared that it was his duty to perform civil marriages. "He would read to them, quickly, a kind of ritual, and, after they were married and he had signed the marriage certificate, he would open a drawer in his desk which contained a mass of bills that had been contributed by bridegrooms—some 20's, some 10's and some of smaller amounts. According to the testimony offered by the government, he would at times merely look toward the bills, holding the marriage certificate, and wait for a contribution; at other times he would say to the bridegroom, 'It is up to you'; at other times, as McCormick waited, holding the certificate, the bridegroom would ask if there was any charge, and McCormick would say, 'Whatever you feel like.' . . He admitted on the stand that he received contributions from more than half the bridegrooms, and they averaged in the course of a year 'around $16,000.' "

The court held that McCormick could not reasonably treat these items as gifts. His conviction was sustained.

(C) In *Bogardus v. Commissioner,* 302 U.S. 34 (1937), the payments were made by a corporation to employees of a predecessor corporation who were not retained when the predecessor was taken over by the company which made the payments. It was held that the amounts received by the former employees were not income to them. Were they deductible by the company which paid them?

(D) *Schall v. Commissioner,* 174 F.2d 893 (C.A.5th, 1949), and *Mutch v. Commissioner,* 209 F.2d 390 (C.A.3d, 1954), involved payments to clergymen. On their retirement, they were voted a modest "honorarium." It was held in each case that this was not income. The Treasury accepted this as applied to ministers and rabbis. Rev.Rul. 55–422, 1955-1 Cum.Bull. 14.

COMMISSIONER v. DUBERSTEIN

Supreme Court of the United States, 1960. — U.S. —.

[Two cases were decided in this opinion. No. 376, *Commissioner v. Duberstein,* involved a Cadillac car which was given to Duberstein by Berman because Duberstein had been helpful in suggesting customers to Berman. There was no prior arrangement for compensation, and Duberstein did not expect to be paid. The Court of Appeals held that this was not income, reversing the Tax Court.

[In No. 546, *Stanton v. United States,* the taxpayer had been comptroller of Trinity Church, and manager of its real estate. He resigned in 1942. The directors then voted him "a gratuity" of $20,000. There was no enforceable right or claim for any such payment. The Court of Appeals held that this was income, reversing the District Court.]

MR. JUSTICE BRENNAN delivered the opinion of the Court. . . .

First. The Government suggests that we promulgate a new "test" in this area to serve as a standard to be applied by the lower courts and by the Tax Court in dealing with the numerous cases that arise.[6] We reject this invitation. We are of opinion that the governing principles are necessarily general and have already been spelled out in the opinions of this Court, and that the problem is one which, under the present statutory framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases. The cases at bar are fair examples of the settings in which the problem usually arises. They present situations in which payments have been made in a context with business overtones—an employer making a payment to a retiring employee; a businessman giving something of value to another businessman who has been of advantage to him in his business. In this context, we review the law as established by the prior cases here.

The course of decision here makes it plain that the statute does not use the term "gift" in the common-law sense, but in a more colloquial sense. This Court has indicated that a voluntary executed transfer of his property by one to another, without any con-

[6] The Government's proposed test is stated: "Gifts should be defined as transfers of property made for personal as distinguished from business reasons."

sideration or compensation therefor, though a common-law gift, is not necessarily a "gift" within the meaning of the statute. For the Court has shown that the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift. *Old Colony Trust Co. v. Commissioner,* 279 U.S. 716, 730. And, importantly, if the payment proceeds primarily from "the constraining force of any moral or legal duty," or from "the incentive of anticipated benefit" of an economic nature, *Bogardus v. Commissioner,* 302 U.S. 34, 41, it is not a gift. And, conversely, "[w]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." *Robertson* v. *United States,* 343 U.S. 711, 714.[7] . . .

The Government says that this "intention" of the transferor cannot mean what the cases on the common-law concept of gift call "donative intent." With that we are in agreement, for our decisions fully support this. Moreover, the *Bogardus* case itself makes it plain that the donor's characterization of his action is not determinative—that there must be an objective inquiry as to whether what is called a gift amounts to it in reality. 302 U.S., at 40. . . .

Second. The Government's proposed "test," while apparently simple and precise in its formulation, depends frankly on a set of "principles" or "presumptions" derived from the decided cases, and concededly subject to various exceptions; and it involves various corollaries, which add to its detail. Were we to promulgate this test as a matter of law, and accept with it its various presuppositions and stated consequences, we would be passing far beyond the requirements of the cases before us, and would be painting on a large canvas with indeed a broad brush. The Government derives its test from such propositions as the following: That payments by an employer to an employee, even though voluntary, ought, by and large, to be taxable; That the concept of a gift is inconsistent with a payment's being a deductible business expense; That a gift involves "personal" elements; That a business corporation cannot properly make a gift of its assets. The Government admits that there are exceptions and qualifications to these propositions. We think, to the extent they are correct, that these propositions are not principles of law but rather maxims of experience that the tribunals which have tried the facts of cases in this area have enunciated in explaining their factual determinations. . . The taxing statute does not make nondeductibility by the transferor a condition on the "gift" exclusion; nor does it draw any distinction, in terms, between transfers by corporations and individuals, as to the availability of the "gift" exclusion to the trans-

[7] The cases including "tips" in gross income are classic examples of this. See, *e. g., Roberts v. Commissioner,* 176 F.2d 221.

feree. The conclusion whether a transfer amounts to a "gift" is one that must be reached on consideration of all the factors. . . .

Third. Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact. . . .

This conclusion may not satisfy an academic desire for tidiness, symmetry and precision in this area, any more than a system based on the determinations of various fact-finders ordinarily does. But we see it as implicit in the present statutory treatment of the exclusion for gifts, and in the variety of forums in which federal income tax cases can be tried. If there is fear of undue uncertainty or overmuch litigation, Congress may make more precise its treatment of the matter by singling out certain factors and making them determinative of the matter, as it has done in one field of the "gift" exclusion's former application, that of prizes and awards. . . . But the question here remains basically one of fact, for determination on a case-by-case basis.

One consequence of this is that appellate review of determinations in this field must be quite restricted. Where a jury has tried the matter upon correct instructions, the only inquiry is whether it cannot be said that reasonable men could reach differing conclusions on the issue. . . . Where the trial has been by a judge without a jury, the judge's findings must stand unless "clearly erroneous." . . . And Congress has in the most explicit terms attached the identical weight to the findings of the Tax Court. I.R.C., § 7482(a).

Fourth. A majority of the Court is in accord with the principles just outlined. And, applying them to the *Duberstein* case, we are in agreement, on the evidence we have set forth, that it cannot be said that the conclusion of the Tax Court was "clearly erroneous." It seems to us plain that as trier of the facts it was warranted in concluding that despite the characterization of the transfer of the Cadillac by the parties and the absence of any obligation, even of a moral nature, to make it, it was at bottom a recompense for Duberstein's past services, or an inducement for him to be of further service in the future. We cannot say with the Court of Appeals that such a conclusion was "mere suspicion" on the Tax Court's part. To us it appears based in the sort of

informed experience with human affairs that fact-finding tribunals should bring to this task.

As to *Stanton,* we are in disagreement. To four of us, it is critical here that the District Court as trier of fact made only the simple and unelaborated finding that the transfer in question was a "gift." To be sure, concisenesss is to be strived for, and prolixity avoided, in findings; but, to the four of us, there comes a point where findings become so sparse and conclusory as to give no revelation of what the District Court's concept of the determining facts and legal standard may be. . . . For all that appears, the District Court may have viewed the form of the resolution or the simple absence of legal consideration as conclusive. While the judgment of the Court of Appeals cannot stand, the four of us think there must be further proceedings in the District Court looking toward new and adequate findings of fact. In this, we are joined by MR. JUSTICE WHITTAKER, who agrees that the findings were inadequate, although he does not concur generally in this opinion.

Accordingly, in No. 376, the judgment of this Court is that the judgment of the Court of Appeals is reversed, and in No. 546, that the judgment of the Court of Appeals is vacated, and the case is remanded to the District Court for further proceedings not inconsistent with this opinion.

It is so ordered.[1]

[Opinions by JUSTICES BLACK and FRANKFURTER, concurring in *Duberstein,* and dissenting in *Stanton,* are omitted.]

Note

At the same time, the Court decided *United States v. Kaiser,* — U.S. — (1960). This involved a payment which was made by a union to a non-union member in connection with a strike, a so-called strike benefit payment. A jury found that the payment was a gift, but the District Court entered judgment for the Government, n. o. v. The Court of Appeals reversed. The Supreme Court held that the question was one for the jury, and that judgment should have been entered for the taxpayer on the jury's verdict. Two members of the Court concurred because the payment was made to a non-union member.

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1 MR. JUSTICE HARLAN concurs in the result in No. 376. In No. 546, he would affirm the judgment of the Court of Appeals for the reasons stated by MR. JUSTICE FRANKFURTER. MR. JUSTICE WHITTAKER, agreeing with *Bogardus* that whether a particular transfer is or is not a "gift" may involve "a mixed question of law and fact," 302 U.S., at 39, concurs only in the result of this opinion. MR. JUSTICE DOULGAS dissents, since he is of the view that in each of these two cases there was a gift under the test which the Court fashioned nearly a quarter of a century ago in *Bogardus v. Commissioner,* 302 U.S. 34.

Does income have to be received in cash to be taxable? Suppose a company "gives" its president a new convertible each year. Or suppose it arranges to have all his groceries delivered to his residence. Does he have income? When income is received in property, how is the amount to be included in the tax return determined?

Read the apartment [illegible] benefit to the corporation also: case & not solely for their [illegible] it was additional compensation & prior is [illegible] would not follow [illegible] include this in any part of it [illegible] Don't [illegible] life

OLIN O. ELLIS

Tax Court of the United States, 1946. 6 T.C. 138.

Findings of Fact

Petitioner was president, chairman of the board of directors, and a stockholder of Guilford Realty Company, a Maryland corporation, (hereinafter referred to as Guilford).

Guilford is a real estate holding company, which owns and operates nine apartment buildings and two public garages in Baltimore. It owns all of the issued and outstanding stock of the Mid-City Rent-A-Car Service, Inc., (hereinafter referred to as Mid-City) and of the Club Apartments Company (hereinafter referred to as Club), of each of which petitioner is president. The three corporations occupy office space at 3330 St. Paul Street, Baltimore, next door to the Cambridge Arms Apartments, where petitioner lives.

The Cambridge Arms is the largest of the nine apartment buildings owned by Guilford. It is seven stories in height, contains ninety-six apartments, has three elevators, a switchboard, heating plant, and six compressors which supply cooled air.

Guilford had issued and outstanding 5,983 shares of $100 par value preferred stock, of which petitioner owned 505 shares. It also had issued and outstanding 28,624 shares of $1.00 par value common stock, of which petitioner owned 1,952 shares. In all, Guilford had 107 preferred stockholders and 135 common stockholders.

In 1943 petitioner received a salary from Guilford of $7,525, a salary from Mid-City of $5,200, and a salary from Club of $1,325. In addition thereto, he received rent-free an apartment in the Cambridge Arms of an agreed fair rental value of $1,800 per year. He has occupied this apartment since sometime prior to October, 1940, rent-free. Petitioner's cash salary from Guilford prior to 1943 was $7,800 per year. Although his cash salary from Guilford was decreased in 1943 he received increases from Mid-City and Club, thereby increasing his over-all salary for that year.

Prior to October, 1940, the Cambridge Arms had a manager named Combs, who, in addition to occupying rent-free an apartment with an annual rental value of $1,000, received a cash sal-

ary. He acted both as day and night manager. In October, 1940, because of the illness of his wife, Combs moved from the Cambridge Arms and relinquished his duties as night manager. He continued, however, as day manager at the same cash salary as he had theretofore received.

After that time petitioner acted as night manager, serving daily from 5:30 P.M. until 8:00 A.M., the next morning. During the day he was available for consultations with the day engineer. During the hours petitioner has acted as night manager the tenants have called upon him for services such as telephone connections, additional heat, refrigeration, electrical services, quieting noisy tenants, and the like. A 79-year old employee is also available but he has acted chiefly as switchboard and elevator operator. Petitioner has been called about twice a night for various services, and once or twice each week he has been called after 10:00 P.M.

It is the policy of Guilford to require the managers of their apartment buildings to live in the building.

It is the practice among all large apartment houses in Baltimore to require their managers to reside on the premises.

Petitioner could not perform the various duties as night manager if he were not living in the Cambridge Arms.

The apartment was furnished petitioner partly because Guilford wanted him to live on the premises and partly to compensate him for his services.

The apartment was not furnished petitioner rent-free for the sole convenience of Guilford.

Opinion.

OPPER, JUDGE. Respondent's regulations eliminate from taxable income the fair value of "living quarters * * * furnished to employees for the convenience of the employer," Regulations 111, sec. 29.22(a)-3. We read the present record as demonstrating without appreciable qualification that the living quarters furnished to petitioner were to some extent for his employer's convenience.

Unlike such cases as *Arthur Benaglia,* 36 B.T.A. 838, however, it is impossible to find here that petitioner's rent-free occupancy of his living quarters was "solely" for the employer's convenience. See also *Greene v. Kanne,* 23 A.F.T.R. 1141; *Renton v. Kanne,* 23 A.F.T.R. 1143 (D.C.Hawaii). Not only had petitioner occupied the apartment before he undertook the duties which made his residence there advantageous to the owner, but he testified that it would be correct to say "that in arranging for you [petitioner] to live in that apartment house it is partly

for the reason that they [the employer] want you to live in the premises, and partly to compensate you for your work * * *."

Under the circumstances operative here we regard the outer limit of the value of petitioner's apartment which can be attributed to the employer's convenience as the rental value of the living quarters furnished to petitioner's predecessor which, as set forth in our findings, was $1,000 a year. While perhaps it might be said in other situations where employer and employee are dealing at arm's length that the best evidence of the measure of the employer's convenience is the value of the premises actually appropriated to the employee's use, here petitioner's relation to his employer as director, president, stockholder, and employee in another capacity eliminates the acceptability of such a test.

But for the reasons stated we regard respondent's determination as contrary in principle to his regulations. It is true that in *Ralph Kitchen,* 11 B.T.A. 855, we refused to allow an exclusion of any amount unless the services furnished were "solely" for the convenience of the employer. Neither by word nor implication, however, does that concept appear in the regulations and in so far as the *Kitchen* case is to the contrary it will no longer be followed. Respondent's determination is disapproved to the extent that it disallows the exclusion from gross income of $1,000 out of the total sum of $1,800, which latter amount is agreed to be the full rental value of petitioner's apartment.

Reviewed by the Court.

Decision will be entered under Rule 50.

Notes

(A) Some aspects of this question are now covered by **sec. 119** of the 1954 Code.[1] See also sec. 107, exempting the rental value of a parsonage, and also a rental allowance paid to a minister. The regulations have long granted an exemption for quarters furnished to military personnel, and to commutation in lieu of quarters. See sec. 1.61–2(b) of the Income Tax Regulations. See also Rev.Ruls. 60–65 and 60–66, 1960–1 Cum.Bull. ——, ——. With respect to this, see Rauch, "Parity for Federal Income Taxpayers," 32 Bull.Nat.Tax Ass'n 281 (1947).

The general question is discussed in Kletzing, "Tax Treatment of Compensation in Kind," 37 Calif.L.Rev. 628 (1949). It has extensive ramifications in other areas, such as the Social Security laws, state unemployment insurance acts, the Fair Labor Standards Act, and state workmen's compensation acts. The results reached are not always consistent. For example, the value of room and board is included in "wages," on which the

[1] The Regulations under sec. 119 are sec. 1.119–1 of the Income Tax Regulations.

Employment Taxes (for social security purposes) are imposed. See sec. 3121 of the 1954 Code, and sec. 408.226 of Regulations 128.

The provision now found in sec. 119 of the 1954 Code was new in that statute, and is the first legislative treatment of the problem. Does it answer all of the questions? See Erbacher, "Meals and Lodging Furnished for Convenience of Employer," 32 Taxes 826 (1954); "Meals and Lodging under the 1954 Code," 53 Mich. L.Rev. 871 (1955); Gutkin and Beck, "Some Problems in Convenience of the Employer," 36 Taxes 153 (1956). Should the President pay tax on the fair rental value of the White House? Will there be a tendency now for corporations to provide residences for their presidents and other officers (perhaps for all employees) "at the place of employment"?

(B) The Treasury has ruled that the exemption of sec. 119 does not apply to meals and lodging furnished to members of the family of the employee. Rev.Rul. 59–409, 1959–2 Cum.Bull. 48.

(C) Suppose that the employer fixes a salary for the position. Then if the employee receives quarters a payroll deduction is made from his salary in the amount of the rental value of the quarters. Is this within the "convenience of the employer" test, so that the value of the quarters is exempt from tax? In *Boykin v. Commissioner*, 260 F.2d 249 (C.A.8th, 1958), reversing the Tax Court, this question was answered in the affirmative. The Treasury has announced that it will accept the *Boykin* decision. Rev.Rul. 59–307, 1959–2 Cum.Bull. 48.

(D) *Commissioner v. Doak*, 234 F.2d 704 (C.A.4th, 1956), involved a hotel operated by a partnership. Meals, lodging, and utilities were furnished to partners who were active in the conduct of the business. It was held that the expense of providing these items could not be deducted by the partnership. The partners were not employees of the partnership, and the items were not furnished "for the convenience of the employer." See "Status of Meals and Lodging of Self-Employed Taxpayer," 42 Cornell L.Q. 433 (1957), and Note in 52 Northwestern L.Rev. 129 (1957).

The same result was reached in *Commissioner v. Robinson*, 273 F.2d 503 (C.A.3d, 1959), involving a hotel operated by a husband and wife as sole proprietors.

Fringe Benefits

Suppose the employer installs air conditioning. Is this income to the employee? Suppose he puts in a water cooler? Suppose he puts in a free coke machine? What if he furnishes uniforms to elevator operators? Suppose he furnished free clothing to all employees?

The regulations have long contained a provision under which premiums paid on group term life insurance policies for employees are not taxable. See sec. 1.61–2(d)(2) of the Income Tax Regulations. Does this apply to hospitalization insurance premiums?—or payment of the cost of medical care? With

respect to accident and health plans, see sec. 106 of the 1954 Code. The Regulations under this are sec. 1.106–1 of the Income Tax Regulations.

Suppose the employer provides cars for some of his employees—or country club memberships—or expense paid vacations. Does the employee have income? What about recreational facilities, such as swimming pools, or hunting lodges—or yachts? Reimbursement for commuting expenses?—or free bus service to the plant? What is the limit of the "fringe" principle? Is there any risk that a large part of "income" payments may in time come to be paid in kind if tax exemption is widely extended to them? See Macaulay, Fringe Benefits and Their Federal Tax Treatment (1959), reviewed by Walter J. Blum in 12 Stanford L. Rev. 702 (1960).[1]

REVENUE RULING 59–58

Internal Revenue Service, 1959. 1959–1 Cum.Bull. 17.

Advice has been requested whether the value of a turkey, ham, or other item of merchandise purchased by an employer and distributed generally to each of the employees engaged in his business at Christmas, or a comparable holiday, constitutes wages subject to income tax withholding or income subject to tax for income tax purposes, and whether the cost of such items is deductible by the employer as an ordinary and necessary business expense.

Section 31.3401(a)–1(b)(10) of the Withholding Tax Regulations provides that, ordinarily, facilities or privileges (such as entertainment, medical services, or so-called "courtesy" discounts on purchases), furnished by an employer to his employees generally, are not considered as wages subject to withholding if such facilities or privileges are of relatively small value and are furnished by the employer merely as a means of promoting the health, good will, contentment, or efficiency of his employees. Similar provisions are contained in the regulations pertaining to the employment taxes imposed by the Federal Unemployment Contributions Act and the Federal Unemployment Tax Act (Chapters 21 and 23 of the Internal Revenue Code of 1954). See sections 31.3121(a)–1(f) and 31.3306(b)–1(f) of such regulations.

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1 For discussions, see Landman, "The Taxability of Fringe Benefits," 33 Taxes 173 (1955); Fisher and Chapman, "Big Costs of Little Fringes," 32 Harv. Bus.Rev. No. 5, p. 35 (1954); Hoffman, "Fringe Benefits for Employees," 31 Taxes 999 (1953); Guttentag, Leonard and Rodewald, "Federal Income Taxation of Fringe Benefits: A Specific Proposal," 6 Nat.Tax.J. 250 (1953); Jacobs, "Glamorous Fringe Benefits," 36 B.U.L.Rev. 151 (1956); Rothschild and Sobernham, "Expense Accounts for Executives," 67 Yale L.J. 1363 (1958); Blake, "Fringe Benefit Programs," 36 Taxes 858 (1958); Bloomenthal, "Taxation of Fringe Benefits of Employees," 8 Clev.-Mar.L.Rev. 173 (1959).

It is accordingly held that the value of a turkey, ham, or other item of merchandise or similar nominal value, distributed by an employer to an employee at Christmas, or a comparable holiday, as part of a general distribution to employees engaged in the business of the employer as a means of promoting their good will, does not constitute wages for Federal Insurance Contributions Act or Federal Unemployment Tax Act purposes.

In view of the small amounts involved, and since it may reasonably be contended in many cases that such items constitute excludable gifts, it is similarly held that the value of such an item of merchandise need not be treated as taxable income by the employee who receives it.

The foregoing rules will not apply to distributions of cash, gift certificates, and similar items of readily convertible cash value, regardless of the amount involved.

It is further held that the cost to the employer of turkeys, hams, and other merchandise of similar nominal value which are distributed generally to the employees engaged in his business, primarily for the business purpose of prompting good relations with his employees, is deductible by the employer under section 162 of the Code as an ordinary and necessary business expense.

DEAN v. COMMISSIONER

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Court of Appeals, Third Circuit, 1951. 187 F.2d 1019.

GOODRICH, CIRCUIT JUDGE. This appeal from the Tax Court raises the question of the correctness of a claim for income tax against the taxpayer based on the rental value of property held in the name of a corporation of which the taxpayer and his wife are the sole shareholders. The facts are simple and undisputed.

The taxpayer and his wife are the sole shareholders in a personal holding company called the Nemours Corporation. The wife owns 80% of the stock. The real estate which is the subject matter of this controversy was owned by the taxpayer's wife prior to her marriage. She and the taxpayer continued to occupy it after their marriage and the taxpayer's wife expended and has continued to expend appreciable sums in keeping up and beautifying the property. In 1931 the Nemours Corporation was indebted to a bank for a large sum. The bank insisted that the residence property above mentioned be transferred to the corporation. This was done. The parties continued to occupy the place as a home following the transfer. The taxpayer was in military service during the late war, but received from the corporation the difference between his military pay and the salary he had previously received. He also shared in the occupancy of the home at such times as he was free to do so.

The Commissioner takes the position that the fair rental value of the residence property is to be included in the taxpayer's gross income under the general provisions of Section 22 of the Internal Revenue Code. The Tax Court agreed with the Commissioner. We do likewise. Although the taxpayer endeavors to distinguish it, we think our decision in Chandler v. Commissioner, 3 Cir., 1941, 119 F.2d 623, governs this case and the discussion therein is, for the most part, applicable here. It was the taxpayer's legal obligation to provide a family home and if he did it by the occupancy of a property which was held in the name of a corporation of which he was president, we think the fair value of that occupancy was income to him.

The fact that the corporation was simply a means by which the taxpayer and his wife carried on certain business activities does not change the case. We have no reason for thinking that the corporate existence was anything but bona fide. And we think that the real estate deeded to the corporation would clearly have been held to belong to it had the bank had occasion, which it did not, to take advantage of the corporation's title to the property. Our position is not based upon any thought that there is in this case any suggestion of tax evasion or avoidance. It is instead based upon taxpayer's valuable occupation of the corporation real estate.

The decision of the Tax Court will be affirmed.

Notes

(A) Suppose the taxpayer had owned the house himself. Would he have been subject to income tax on account of the fair rental value of the premises occupied by himself and his family? Suppose the house had been owned outright by his wife. Would he have been subject to income tax on the fair market value of the house on the ground that it was utilized as a means of discharging his obligation to provide support for his family? Why should the result be different when the house is owned by a corporation of which he and his wife are the sole stockholders?

What is the nature of the income in this case? Is it a dividend? If so, should not 80% of the income be attributable to the wife since she owned 80% of the stock? Might there be a gift involved from the wife to the husband? Does the corporation have any sort of income from the fact that the taxpayer here uses the house?

(B) In *Greenspon v. Commissioner,* 229 F.2d 947 (C.A.8th, 1956), the taxpayer owned a farm where he lived. He was president and principal stockholder of a corporation, and the corporation spent large sums fixing up the farm as a horticultural showplace, where customers of the company were entertained. The court held that the farm expenses were not deductible by the corporation, and that they were taxable to the individual taxpayer as a constructive dividend from the corporation.

Benefit derived from the ownership of property—as a house, or beautiful paintings, or a suit of clothes—is known as "imputed income," and is regarded as income by economists.[1] Consider the statement that "If two women do their own washing, neither has income, but if each one does the other's washing, both have income." Is this sound? Is income an absolute concept, or are there some things which are not income within the general language of the statute, but which Congress might constitutionally make subject to an income tax by specific reference?

Could Congress validly provide (as is done in the English income tax[2]) that the rental value of a house owned by a taxpayer must be included and taxed as income? *Cf. Helvering v. Independent Life Ins. Co.*, 292 U.S. 371, 378–379 (1934), where the Court said: "If the statute lays taxes on the part of the building occupied by the owner or upon the rental value of that space, it cannot be sustained, for that would be to lay a direct tax requiring apportionment. . . . The rental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment." Would this dictum stand up today?

Beneficiaries of Deceased Employees

In I.T. 3329, 1939–2 Cum.Bull. 153, the Treasury ruled that a payment made by a corporation to the widow of a deceased employee was not taxable as income to her—since she had performed no services for the company—although it was deductible by the payor. The payment there was a year's salary of the deceased employee. Where, however, there was a contractual obligation with the employee that the payment would be made to the widow, or it was paid pursuant to a "plan," then the amount received by the widow was ruled to be income to her. I.T. 3840, 1947–1 Cum.Bull. 7. The same result was reached where the payment was made to the estate of the deceased employee. *Estate of Edward Bausch v. Commissioner*, 186 F.2d 313 (C.A.2d, 1951). In I.T. 4027, 1950–2 Cum.Bull. 9, the Commissioner revoked I.T. 3329, and held "that payments made by an employer to the widow of a deceased officer or employee, in consideration of services rendered by the officer or employee, are includible in the gross income of the widow."[3]

In cases arising under the 1939 Code, courts have held a payment to the wife of a deceased corporation president in the amount of $20,000 in one case, and $35,000 in another, were gifts and not taxable to the widow, even though deducted by the donor corporation as an expense. *Bounds v. United States*,

[1] See Marsh, "The Taxation of Imputed Income," 58 Pol.Sci.Q. 514 (1943).

[2] See Forbes, Schedule "A" Tax—Its Assessment and Collection (1939). See also Simon, Personal Income Taxation (1938), c. V, on "Income in Kind."

[3] See Flechner, "Tax Consequences of Payments to Widows," 29 Taxes 629 (1953); Susswein, "'Deathly' Benefit Payments," 31 Taxes 283 (1953); Scharf and Ouchterloney, "Death Benefit Payments," 30 Taxes 789 (1952).

262 F.2d 876 (C.A.4th, 1958); *United States v. Allinger,* 275 F.2d 421 (C.A.6th, 1960).

For 1954 and later years this question is affected by **sec. 101(b)** of the 1954 Code, under which up to $5,000 may be paid to the beneficiaries of a deceased employee free of income tax.[4] This is based upon a provision which was first enacted (in somewhat different form) in 1951 as an amendment to sec. 22(b)(1) of the Code of 1939.[5] Note that nothing in the way of a "contract" or "plan" is required under the 1954 provision.

Regulations under sec. 101 have been issued as secs. 1.101–1 to 1.101–6 of the Income Tax Regulations.

Note

In *United States v. Reed,* 277 F.2d 456 (C.A.6th, 1960), arising under the 1954 Code, it was held that a payment of $50,000 to a widow was wholly exempt as a gift.

Prizes and Awards

Sec. 74 of the 1954 Code

For many years, there was much controversy about the taxability of awards and prizes. In *McDermott v. Commissioner,* 150 F.2d 585 (C.A.D.C.1945), it was held that the Ross Essay Prize awarded by the American Bar Association was not taxable, on the ground that the winner simply became, for the time being, the beneficiary of a charitable trust. (Does a non-paying patient in a ward of a hospital have income from the services rendered to him?) But the Treasury refused to follow the *McDermott* case (I.T. 3960, 1949–2 Cum.Bull. 13), and the courts generally applied a "performance of services" test.[6] This was confirmed, rather summarily, by the Supreme Court in the following case.

4 See Cardon, "Gratuitous Death Benefits under the 1954 Code," 11 Tax Exec. 352 (1959); Groh, "Voluntary Payments to an Employee's Widow," 36 Taxes 333 (1958); Yohlin, "Employer Payments to the Widow of a Deceased Employee," 34 Taxes 87 (1956).

5 For discussions, see Nelson, "The New $5,000 Death Benefit," 31 Taxes 629 (1953); Susswein, "'Deathly' Benefit Payments," 31 Taxes 283 (1953); Scharf and Ouchterloney, "Death Benefit Payments," 30 Taxes 789 (1952).

6 See Soll, "Essay Competitions and Income Tax Contests," 6 Tax L.Rev. 109 (1950); Lourd and Lourd, "The Taxability of Prize Winnings," 27 Taxes 966 (1949).

ROBERTSON v. UNITED STATES

Supreme Court of the United States, 1952. 343 U.S. 711.

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

Petitioner is a musician and composer who between the years 1936 and 1939 composed a symphony. In 1945 Henry H. Reichhold, a philanthropist, established a music award offering $25,000, $5,000, and $2,500 for the three best symphonic works written by native-born composers of this hemisphere. The terms of the offer provided that none of the compositions could be published or publicly performed prior to entry in the contest and that each composition receiving an award would remain the property of the composer except that he would grant the Detroit Orchestra, Inc., (1) all synchronization rights as applied to motion pictures, (2) all mechanical rights as applied to phonograph recordings, electrical transcriptions and music rolls, and (3) the exclusive right to authorize the first performance of the composition in each of the countries whose citizens were eligible to enter the contest and to designate the publisher of the composition.

Petitioner submitted his symphony and on December 14, 1947, won the $25,000 award. He included that amount in his 1947 income tax return as gross income, claimed the benefits of § 107(b) of the Internal Revenue Code (26 U.S.C. (1946 ed.) § 107(b), 53 Stat. 878, as amended), and computed the tax as though the $25,000 had been received ratably during the years 1937, 1938, and 1939. Thereafter he filed a claim for refund on the ground that the award constituted a nontaxable gift.[1] The Commissioner did not allow the claim but determined a deficiency on the ground that the tax should have been computed under § 107(b) as though the award had been ratably received over the three-year period ending with 1947. Petitioner paid the deficiency, filed a supplemental claim for refund, and brought this suit to obtain it. The District Court held that the award was a gift and not taxable by reason of § 22(b)(3) of the Internal Revenue Code. The Court of Appeals reversed. 190 F.2d 680. The case is here on certiorari because of the conflict between that decision and *McDermott v. Commissioner*, 150 F.2d 585, decided by the Court of Appeals for the District of Columbia. And see *Williams v. United States*, 84 F.Supp. 362.

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[1] Section 22(b)(3) of the Internal Revenue Code provides:

"The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

"The value of property acquired by gift, bequest, devise, or inheritance . . . ."

I.

In the legal sense payment of a prize to a winner of a contest is the discharge of a contractual obligation. The acceptance by the contestants of the offer tendered by the sponsor of the contest creates an enforceable contract. See 6 Corbin On Contracts § 1489; Restatement, Contracts, § 521. The discharge of legal obligations—the payment for services rendered or consideration paid pursuant to a contract—is in no sense a gift. The case would be different if an award were made in recognition of past achievements or present abilities, or if payment was given not for services (see *Old Colony Trust Co. v. Commissioner,* 279 U.S. 716, 730), but out of affection, respect, admiration, charity or like impulses. Where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it.

[The second portion of the opinion, relating to the application of sec. 107 of the 1939 Code to the payment in question, is omitted here, and is printed at page 469 below.]

Affirmed.

MR. JUSTICE JACKSON dissents.

Notes

(A) The question is now covered by **sec. 74** of the 1954 Code —which was new in that statute. See sec. 1.74–1 of the Income Tax Regulations. Is a Pulitzer Prize or a Nobel Prize, or the Ames Prize awarded by the Harvard Law School, taxable under this provision? Cf. Rev.Rul. 54–110, 1954–1 Cum.Bull. 28.

Are there any constitutional questions under sec. 74?

(B) Gambling winnings are taxable income. Here there is a contractual relationship, and a transaction entered into for profit. *Riebe v. Commissioner,* 124 F.2d 399 (C.C.A.6th, 1941); *Christian H. Droge,* 35 B.T.A. 829 (1937). Note that sec. 165(d) of the 1954 Code allows the deduction of gambling losses, but not in excess of the amount of gambling gains.

(C) Suppose a person picks up money on the street. Is that income? Suppose he buys a second hand chest, and finds $1,000 hidden in it. Is that income? The Treasury has ruled that "The finder of treasure-trove is in receipt of taxable income." Rev. Rul. 61, 1953–1 Cum.Bull. 17. Cf. "Taxation of Found Property and Other Windfalls," 20 U. of Chi.L.Rev. 748 (1953).

Scholarships and Fellowships

The 1954 Code contains a new provision in sec. 117 relating to the taxability of scholarships and fellowships. See also secs. 1.117–1 through 1.117–4 of the Income Tax Regulations. This should help to clarify a field which has presented a certain number of problems. An ordinary scholarship to a student who is a candidate for a degree is fairly clear. What about a fellowship for further study to a man who already has the final degree in his field? Or a stipend given to a young scientist to enable him to

work on a research project being conducted by an educational institution? In some cases these stipends have been quite large. The Treasury undertook to state its views (before there was any specific statutory provision) in I.T. 4056, 1951–2 Cum.Bull. 8. See also G.C.M. 5581, VIII–1 Cum.Bull. 68 (1929).[1]

See "Fellowships and Scholarships, Prizes and Awards—Ante 1954, Post 1954," 7 Syracuse L.Rev. 130 (1955). With respect to grants for travel expenses, see Rev.Rul. 59–81, 1959–1 Cum.Bull. 37.

Is the value of a room furnished to a proctor includable in gross income? Consider sec. 119 as well as sec. 117.

Alimony

Secs. 71, 215, and 682 of the 1954 Code

Regulations under sec. 71 of the 1954 Code have been issued as sec. 1.71–1 of the Income Tax Regulations. See also sec. 1.215–1 for Regulations under sec. 215, and secs. 1.682(a)–1 through 1.682(c)–1 for Regulations under sec. 682.

In *Gould v. Gould*, 245 U.S. 151 (1917), the Supreme Court held that alimony was not income under the general definition of gross income, and was not taxable to the wife who received it. Similarly, it was not deductible by the husband.

This was the law until 1942, when provisions taxing alimony to the recipient, and allowing it to be deducted by the payor, were first enacted. These provisions were in secs. 22(k), 23(u), and 171 of the old I.R.C. The law under the 1954 Code is substantially unchanged, except that for the first time the provisions are now applicable where there is a written separation agreement, without a court decree of divorce or legal separation.[2]

BAKER v. COMMISSIONER

Court of Appeals, Second Circuit, 1953. 205 F.2d 369.

FRANK, CIRCUIT JUDGE. . . . The separation agreement made between the taxpayer Mr. Baker and his former wife, and incorporated in the divorce decree, provided that he was to pay

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[1] The questions (in advance of the statutory provision) were discussed in "Scholarships, Fellowships and Prizes: Gift or Income?" 38 Minn.L.Rev. 152, (1954); Huberman, "Scholarships, Fellowships and Prizes," 3 Hastings L.J. 116 (1952). See also "Scholarships," 2 Canadian Tax J. 218 (1954).

[2] For discussions under the earlier law, see Kragon and Stoke, "The Marriage Undone: Tax-Wise," 42 Calif.L.Rev. 408 (1954); Wolf, "Income, Gift and Estate Tax Considerations in Marriage and Divorce," 14 Maryland L.Rev. 3 (1954); Bayly, "Alimony Income and Deduction," 32 Taxes 71 (1954); Johnson, "Divorce and Federal Income Taxes," 37 Minn.L.Rev. 413 (1953); McCown, "Tax Pitfalls in Divorce, Alimony and Separate Maintenance," 31 Neb.L.Rev. 509 (1952); Friedland, "Alimony," 28 Taxes 929 (1950).

her $300 per month from September 1, 1946 to August 31, 1947, and $200 a month from September 1, 1947 to August 31, 1952, but that, should she die or remarry, his obligation to make any such payments thereafter would cease.[3] The Tax Court held that these were "installment payments"—within § 22(k) of the Internal Revenue Code—each discharging "a part of an obligation the principal sum of which is . . . specified in the decree". We do not agree.

Section 22(k) differentiates "periodic payments" and "installment payments." The latter, as the wording shows, must be parts of a "principal sum." Here no such sum was explicitly stated in figures. But the Tax Court said: "Simple arithmetic indicates that the principal sum to be paid was $15,600"—in other words, the addition of the several payments. Were there no contingencies, this conclusion might be sound. But there are contingencies which the Tax Court ignored. In doing so, it cited Steinel, 10 T.C. 409, at page 410, where it had said that "the word 'obligation' is used in § 22(k) in its general sense and includes obligations subject to contingencies where those contingencies have not arisen and have not avoided the obligation during the taxable years." We see no justification for this interpretation.

We need not decide whether the words "principal sum" exclude all annuities, even those predictable actuarially, as would be the case here if the sole contingency reducing the payments were the wife's death. For here there was the further contingency of the wife's remarriage, and no proof of any actuarial computations in respect of such a contingency. Since a divorced wife's remarriage—in most instances in this respect unlike her death—depends upon some elements of her own seemingly unpredictable choosing, the computation seems as far beyond the reach of an educated guess as what will be the first name of the man or woman who will become President of the United States in 1983. True, in *Commissioner of Internal Revenue v. Maresi*, 2 Cir., 156 F.2d 929, we affirmed a decision of the Tax Court, 6 T.C. 582, which relied on American experience tables, relating to the chances of the continued celibacy of widows, in determining the chance that a particular divorced woman would take with a new spouse.[4] In the *Maresi* case, however, the question was whether we should appraise a concededly deductible estate at zero; we said, in effect, that there were means to guess at its value, unreliable perhaps, but still better than nothing, and that in such circumstances a poor guess was better than an almost certain mistake, *i. e.,* to

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3 Provisions for reduction of these payments in certain circumstances need not here be considered, for, as the Tax Court said, their only relevant effect was to extend the prescribed period of payments from a period of six years to a maximum of seven years and eight months.

4 That here the wife in fact remarried in September, 1949 is irrelevant.

say that the estate was worth nothing. And we there applied a statute dealing with the valuation of interests which, by their very nature, are guessy. But the language of the statute before us in the instant case—"the principal sum . . . specified in the decree"—clearly implies an amount of a fairly definite character, and thus carries with it no such suggestion of uncertainty.[5] Consequently, in this respect, we reverse the decision of the Tax Court. . . .

Reversed in part.

Notes

(A) In G.C.M. 25,250, 1947–2 Cum.Bull. 32, it was ruled that alimony payments made in connection with a Mexican divorce were deductible under the predecessor of the present sec. 215. In I.T. 4001, 1950–1 Cum.Bull. 27, premiums paid by a husband on a life insurance policy absolutely assigned to his divorced wife were held to be income to her and deductible by him. But where there was no assignment and the former wife was only the revocable or contingent beneficiary, the premium payments are not income to the wife nor deductible by the husband.

(B) Many rather technical questions arise under the provisions. Some illustrations are:

(1) In *Commissioner v. Blum,* 187 F.2d 177 (C.A.7th, 1951), cert. den. 342 U.S. 819 (1951), it appeared that a separation agreement was entered into on February 27, 1935. It called for payments to be made to the wife, the last of which was to be paid on March 1, 1945. The agreement was incorporated into a divorce decree which was entered on March 2, 1935. The court held that the ten-year period began with the date of the separation agreement, since the obligation to make the payments rested on the agreement. Accordingly, the payments qualified as "periodic payments" and were taxable to the wife.[1]

(2) In *Fairbanks v. Commissioner,* 191 F.2d 680 (C.A.9th, 1951), cert. den. 343 U.S. 915 (1952), it was held that alimony payments received by a divorced wife from a trust, after the husband's death, were taxable as income to the wife, although the basic obligation of support had then ceased.

(3) In *Lerner v. Commissioner,* 195 F.2d 296 (C.A.2d, 1952), it was held that payments were "incident to a decree of divorce" when they were made under a separation agreement which was followed rather promptly by a divorce, although the separation agreement was not incorporated into the divorce decree or referred to in it.[2]

(C) Only payments made for the wife's own use are taxable to her and deductible by the husband. Payments made to the

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[5] Cf. Rohmer v. Commissioner, 2 Cir., 153 F.2d 61, 65: "It is well to remember that the concepts employed in construing one section of a statute are not necessarily pertinent when construing another with a distinguishable background."

[1] See Orin, "Alimony Payments—Periodic or Installment?" 33 Taxes 414 (1955).

[2] See "Taxation of Support Payments to a Divorced Spouse under Private Agreement," 61 Yale L.J. 1198 (1952).

wife for the support of minor children are not alimony. See *Velma B. Vargason*, 22 T.C. 100 (1954), where a decree entered in 1946 said that payments were for the support of the wife and issue of the marriage. This was a mistake. In 1950, the court entered a decree saying the payments were for the support of children only and made this retroactive to 1946. It was held that amounts received by the wife in 1947 were not taxable to her.

See, generally, "Alimony or Child Support? Tax Consequences of an Allocation." 45 Va.L.Rev. 1362 (1959); Horne, "Tax Pitfalls in Alimony and Separation Payments," 35 Taxes 751 (1957).

Gould v. Gould, the original alimony case, was also notable for its approach, which has since been discarded. In *Gould v. Gould,* the Court said: "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen."

For many years this passage was regularly quoted in lawyers' briefs. But it is of no avail now. The more recent approach is shown by the opinion of Mr. Justice Stone in *White v. United States,* 305 U.S. 281, 292 (1938): "We are not impressed by the argument that, as a question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what the construction fairly should be." See also *Burnet v. Guggenheim,* 288 U.S. 280, 286 (1933); L. Hand, J., in *Commissioner v. Morris,* 90 F.2d 962, 964 (C.C.A.2d 1937).

Compensation for Services—or Tax Free Interest

An illustration of the devices that are sometimes adopted to make the receipt of compensation seem to be something else is found in Rev.Rul. 55–73, 1955–1 Cum.Bull. 236. This ruling involved an underwriter who buys municipal bonds and sells them to the public. When the bonds are issued by the municipality and delivered to the underwriter, they have two kinds of coupons attached. "Class A" coupons mature at six-month intervals over the life of the bonds, and are sold with the bonds. There are also "Class B" coupons, usually running for two or three years, maturing at six-month intervals. The "Class B" coupons are detached and retained by the brokers, evidently with the expectation that they represent "interest" on a state or municipal security which is exempt from tax under sec. 103 of the 1954 Code.

The Treasury ruled that the fair market value of the "Class B" coupons should be included in the taxable income of the under-

writer in the year in which they were received, on the ground that they were payment for services and not interest.

The Treasury also ruled that any gain realized by the underwriter from the sale of the coupons prior to maturity was ordinary income, and that any payments received by the underwriter from the municipality on the maturity of the coupons in excess of the fair market value of the coupons when received was also ordinary income. Are these rulings correct?

Illegal Income

In *United States v. Sullivan*, 274 U.S. 259 (1927), the Supreme Court held that the income of a bootlegger was subject to tax, despite its illegal origin. What deductions would be allowed on such a return?—wages of employees?—cost of goods sold?—protection money paid to police? For a general discussion, see Geller and Rogers, "How the Federal Income Tax Applies to Illegal and Unlawful Gains," 27 Taxes 214 (1949).

In *Commissioner v. Wilcox*, 327 U.S. 404 (1946), the Court held that money taken by an embezzler was not subject to tax. It pointed out that he had no net gain, since he was subject to an immediate liability to repay as soon as he took any money. If an embezzler's receipts were taxable, would the government's lien for taxes take precedence over the claim of the owner of the money to have his property restored to him?

See "Embezzlement and Income under the Internal Revenue Code," 30 Indiana L.J. 487 (1955).

The next Supreme Court decision was in *Rutkin v. United States*, 343 U.S. 130 (1952). This was a criminal prosecution, the charge being based on failure to report income derived from extortion. In a five to four decision, the majority of the Court distinguished the *Wilcox* case, finding a line between embezzlement, on the one hand, and fraud and extortion, on the other, chiefly on the basis that, in the latter cases, there was consent by the person who gave up the money.

In subsequent cases, the lower courts found difficulty in applying this distinction. In a number of cases, they held, in varying circumstances, that money taken was not "embezzled," and thus was within the *Rutkin* case. See *Kann v. Commissioner*, 210 F.2d 247 (C.A.3d, 1953), cert. den. 347 U.S. 967 (1954); *Marienfeld v. United States*, 214 F.2d 632 (C.A.8th, 1954).

Finally, in *United States v. James*, 273 F.2d 5 (C.A.7th, 1959), a criminal conviction was sustained where the proof showed failure to return embezzled money for income tax purposes. The court said that "the claim of right test of *Wilcox*" had been overruled by "the economic use and benefit test" of *Rutkin*. On

May 16, 1960, the Supreme Court granted a writ of certiorari to review this decision. The Supreme Court's opinion, when available, will doubtless chart the future state of the law in this area.

Notes

(A) If embezzled money is income, what will be the situation if the embezzler is caught while he still has some or all of the money? Naturally the owner of the money will claim it. Will this give the embezzler a tax deduction? If the embezzler does not pay his tax on the embezzled money, will the government be entitled to a lien on the funds for the tax liability? Will that lien take priority against the claim of the person from whom the money was embezzled?

(B) For discussion, prior to the Supreme Court's decision in the *James* case, see " 'Wilcox' or 'Rutkin'—Is the Fog Lifting?" 34 Taxes 109 (1956); Durkan, "The Irreconcilable Wilcox and Rutkin Doctrines," 35 Taxes 659 (1957); Spilky and Halprin, "Embezzlers Have Tax Problems Too," 36 Taxes 798 (1958); "Taxation of Misappropriated Property: The Decline and Incomplete Fall of *Wilcox*," 62 Yale L.J. 662 (1953); "Income Tax Liability of Embezzlers," 16 U. of Pitt.L.Rev. 188 (1955). For earlier discussions, see "Income Tax Consequences of Theft," 35 Va.L.Rev. 759 (1949); Geller and Rogers, "Embezzlement Has Its Problems Too," 26 Taxes 1097 (1948).

Damages

Are damages for breach of promise of marriage taxable as income? See *Mrs. Lyde McDonald,* 9 B.T.A. 1340 (1928). Or damages for alienation of affections? Sol.Op. 132, I–1 Cum.Bull. 92 (1922). Or for libel and slander? *C. A. Hawkins,* 6 B.T.A. 1023 (1927). See Blumenthal, "Taxation of Damages," 21 U. of Pitts. L.Rev. 25 (1959); Moss, "Taxation of Damages and Recoveries," 36 Taxes 273 (1958).

If damages for personal injuries are not taxable as income, should this be taken into account by the jury in fixing the amount of damages, particularly when loss of earning power is an element in the damages? Is the defendant entitled to have an instruction given to the jury that the amount they award will not be taxable, and should consequently be reduced by the amount of the tax saved insofar as it is intended to replace future earnings?

DEMPSEY v. THOMPSON, 363 Mo. 339, 251 S.W.2d 42 (1952): HOLLINGSWORTH, J. . . . Present economic conditions are such that most citizens, most jurors, are not only conscious of, but acutely sensitive to, the impact of income taxes. Under the Federal and State income tax laws of both Arkansas and Missouri the net income of all persons is taxable except such as is specifically exempted. Few persons, other than those who have had special occasion to learn otherwise, have any knowledge of the exemption involved in this case. It is reasonable to assume

the average juror would believe the award involved in this case to be subject to such taxes. It seems clear, therefore, that in order to avoid any harm such a misconception could bring about, it would be competent and desirable to instruct the jury that an award of damages for personal injuries is not subject to Federal or State income taxes. The instruction could be in substantially this form: "You are instructed that any award made to plaintiff as damages in this case, if any award is made, is not subject to Federal or State income taxes, and you should not consider such taxes in fixing the amount of any award made plaintiff, if any you make."

Can there be any sound reason for not so instructing the jury? We can think of none. Surely, the plaintiff has no right to receive an enhanced award due to a possible, and, we think, probable misconception on the part of a jury that the amount allowed by it will be reduced by income taxes. Such an instruction would at once and for all purposes take the subject of income taxes out of the case.

We are now convinced and hold that an instruction substantially in the form above outlined should have been given in this case, and that the case of *Hilton v. Thompson,* 360 Mo. 177, 227 S.W.2d 675, insofar as it is in conflict with the ruling here made, should no longer be followed. . . .

Note

See also *O'Connor v. United States,* 269 F.2d 578, 584–585 (C. A.2d, 1959).

The House of Lords has held in England that income taxes should be taken into account in fixing the amount of damages for personal injuries. *British Transportation Commission v. Gourley,* [1956] A.C. 185, noted in 72 L.Q.Rev. 153 (1956). See Stevenson and Orr, "The Tax Element in Damages," [1956] British Tax Rev. 5; "Further Developments of the 'Gourley' Doctrine," [1956] British Tax Rev. 297; Hall, "Taxation of Compensation for Loss of Income," 73 L.Q.Rev. 212 (1957); Ilersic, "The Gourley Case—Implications and Consequences," 6 Can.Tax J. 434 (1958); Jolowicz, "Damages and Income Tax," [1959] Cambridge L.J. 86. See also Nordstrom, "Income Taxes and Personal Injury Awards," 19 Ohio St.L.J. 212 (1958), and 10 U. of Fla.L.Rev. 98 (1957), commenting on *Mitchell v. Emblade,* 80 Ariz. 398, 298 P.2d 1034 (1956); Morris and Nordstrom, "Personal Injury Recoveries and the Federal Income Tax Law," 46 A.B.A.J. 274 (1960).

COMMISSIONER v. GLENSHAW GLASS CO.

Supreme Court of the United States, 1955. 348 U.S. 426.

MR. CHIEF JUSTICE WARREN delivered the opinion of the Court.

This litigation involves two cases with independent factual backgrounds yet presenting the identical issue. The two cases were consolidated for argument before the Court of Appeals for the Third Circuit and were heard *en banc*. The common question is whether money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble damage antitrust recovery must be reported by a taxpayer as gross income under § 22(a) of the Internal Revenue Code of 1939. In a single opinion, 211 F.2d 928, the Court of Appeals affirmed the Tax Court's separate rulings in favor of the taxpayers. 18 T.C. 860, 19 T.C. 637. Because of the frequent recurrence of the question and differing interpretations by the lower courts of this Court's decisions bearing upon the problem, we granted the Commissioner of Internal Revenue's ensuing petition for certiorari. 348 U.S. 813.

The facts of the cases were largely stipulated and are not in dispute. So far as pertinent they are as follows:

Commissioner v. Glenshaw Glass Co.—The Glenshaw Glass Company, a Pennsylvania corporation, manufactures glass bottles and containers. It was engaged in protracted litigation with the Hartford-Empire Company, which manufactures machinery of a character used by Glenshaw. Among the claims advanced by Glenshaw were demands for exemplary damages for fraud[2] and treble damages for injury to its business by reason of Hartford's violation of the federal antitrust laws.[3] In December, 1947, the parties concluded a settlement of all pending litigation, by which Hartford paid Glenshaw approximately $800,000. Through a method of allocation which was approved by the Tax Court, 18 T.C. 860, 870–872, and which is no longer in issue, it was ultimately determined that, of the total settlement, $324,529.94 represented payment of punitive damages for fraud and antitrust violations. Glenshaw did not report this portion of the settlement as income for the tax year involved. The Commissioner determined a deficiency claiming as taxable the entire sum less only deductible legal fees. As previously noted, the Tax Court and the Court of Appeals upheld the taxpayer.

Commissioner v. William Goldman Theatres, Inc.—William Goldman Theatres, Inc., a Delaware corporation operating motion picture houses in Pennsylvania, sued Loew's, Inc., alleging

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2 For the bases of Glenshaw's claim for damages from fraud, see Shawkee Manufacturing Co. v. Hartford-Empire Co., 322 U.S. 271; Hazel-Atlas Glass Co. v. Hartford-Empire Co., 322 U.S. 238.

3 See Hartford-Empire Co. v. United States, 323 U.S. 386, 324 U.S. 570.

a violation of the federal antitrust laws and seeking treble damages. After a holding that a violation had occurred, *William Goldman, Theatres, Inc. v. Loew's, Inc.*, 150 F.2d 738, the case was remanded to the trial court for a determination of damages. It was found that Goldman had suffered a loss of profits equal to $125,000 and was entitled to treble damages in the sum of $375,000. *William Goldman Theatres, Inc. v. Loew's, Inc.*, 69 F.Supp. 103, aff'd, 164 F.2d 1021, cert. denied, 334 U.S. 811. Goldman reported only $125,000 of the recovery as gross income and claimed that the $250,000 balance constituted punitive damages and as such was not taxable. The Tax Court agreed, 19 T.C. 637, and the Court of Appeals, hearing this with the *Glenshaw* case, affirmed. 211 F.2d 928.

It is conceded by the respondents that there is no constitutional barrier to the imposition of a tax on punitive damages. Our question is one of statutory construction: are these payments comprehended by § 22(a)?

The sweeping scope of the controverted statute is readily apparent:

> "SEC. 22. GROSS INCOME.
>
> "(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, *or gains or profits and income derived from any source whatever.* . . ." (Emphasis added.)

This Court has frequently stated that this language was used by Congress to exert in this field "the full measure of its taxing power. *Helvering v. Clifford,* 309 U.S. 331, 334; *Helvering v. Midland Mutual Life Ins. Co.,* 300 U.S. 216, 223; *Douglas v. Willcuts,* 296 U.S. 1, 9; *Irwin v. Gavit,* 268 U.S. 161, 166. Respondents contend that punitive damages, characterized as "windfalls" flowing from the culpable conduct of third parties, are not within the scope of the section. But Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted. *Commissioner v. Jacobson,* 336 U.S. 28, 49; *Helvering v. Stockholms Enskilda Bank,* 293 U.S. 84, 87–91. Thus, the fortuitous gain accruing to a lessor by reason of the forfeiture of a lessee's improvements

on the rented property was taxed in *Helvering v. Bruun,* 309 U.S. 461. Cf. *Robertson v. United States,* 343 U.S. 711; *Rutkin v. United States,* 343 U.S. 130; *United States v. Kirby Lumber Co.,* 284 U.S. 1. Such decisions demonstrate that we cannot but ascribe content to the catchall provision of § 22(a), "gains or profits and income derived from any source whatever." The importance of that phrase has been too frequently recognized since its first appearance in the Revenue Act of 1913 [5] to say now that it adds nothing to the meaning of "gross income."

Nor can we accept respondent's contention that a narrower reading of § 22(a) is required by the Court's characterization of income in *Eisner v. Macomber,* 252 U.S. 189, 207, as "the gain derived from capital, from labor, or from both combined." [6] The Court was there endeavoring to determine whether the distribution of a corporate stock dividend constituted a realized gain to the shareholder, or changed "only the form, not the essence," of his capital investment. *Id.,* at 210. It was held that the taxpayer had "received nothing out of the company's assets for his separate use and benefit." *Id.,* at 211. The distribution, therefore, was held not a taxable event. In that context—distinguishing gain from capital—the definition served a useful purpose. But it was not meant to provide a touchstone to all future gross income questions. *Helvering v. Bruun, supra,* at 468–469; *United States v. Kirby Lumber Co., supra,* at 3.

Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients. Respondents concede, as they must, that the recoveries are taxable to the extent that they compensate for damages actually incurred. It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury. And we find no such evidence of intent to exempt these payments.

It is urged that reenactment of § 22(a) without change since the Board of Tax Appeals held punitive damages nontaxable in

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5 38 Stat. 114, 167.

6 The phrase was derived from Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415, and Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185, two cases construing the Revenue Act of 1909, 36 Stat. 11, 112. Both taxpayers were "wasting asset" corporations, one being engaged in mining, the other in lumbering operations. The definition was applied by the Court to demonstrate a distinction between a return on capital and "a mere conversion of capital assets." Doyle v. Mitchell Bros. Co., supra, at 184. The question raised by the instant case is clearly distinguishable.

Highland Farms Corp., 42 B.T.A. 1314, indicates congressional satisfaction with that holding. Reenactment—particularly without the slightest affirmative indication that Congress ever had the *Highland Farms* decision before it—is an unreliable indicium at best. *Helvering v. Wilshire Oil Co.,* 308 U.S. 90, 100–101; *Koshland v. Helvering,* 298 U.S. 441, 447. Moreover, the Commissioner promptly published his nonacquiescence in this portion of the *Highland Farms* holding [7] and has, before and since, consistently maintained the position that these receipts are taxable.[8] It therefore cannot be said with certitude that Congress intended to carve an exception out of § 22(a)'s pervasive coverage. Nor does the 1954 Code's [9] legislative history, with its reiteration of the proposition that statutory gross income is "all-inclusive," [10] give support to respondent's position. The definition of gross income has been simplified, but no effect upon its present broad scope was intended.[11] Certainly punitive damages cannot reasonably be classified as gifts, cf. *Commissioner v. Jacobson,* 336 U.S. 28, 47–52, nor do they come under any other exemption provision in the Code. We would do violence to the plain meaning of the statute and restrict a clear legislative attempt to bring the taxing power to bear upon all receipts constitutionally taxable were we to say that the payments in question here are not gross income. See *Helvering v. Midland Mutual Life Ins. Co., supra,* at 223.

Reversed.

MR. JUSTICE DOUGLAS dissents.

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7 1941–1 Cum.Bull. 16.

8 The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property. See 2 Cum.Bull. 71; I–1 Cum.Bull. 92, 93; VII–2 Cum.Bull. 123; 1954–1 Cum. Bull. 179, 180. Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.

9 68A Stat. 3 et seq. Section 61(a) of the Internal Revenue Code of 1954, 68A Stat. 17, is the successor to § 22(a) of the 1939 Code.

10 H.R.Rep. No. 1337, 83d Cong., 2d Sess. A18; S.Rep. No. 1622, 83d Cong., 2d Sess. 168.

11 In discussing § 61(a) of the 1954 Code, the House Report states:

"This section corresponds to section 22(a) of the 1939 Code. While the language in existing section 22(a) has been simplified, the all-inclusive nature of statutory gross income has not been affected thereby. Section 61(a) is as broad in scope as section 22(a).

"Section 61(a) provides that gross income includes 'all income from whatever source derived.' This definition is based upon the 16th Amendment and the word 'income' is used in its constitutional sense." H.R.Rep. No. 1337, supra, note 10, at A18.

A virtually identical statement appears in S.Rep. No. 1622, supra, note 10, at 168.

Note

At the same time the Supreme Court decided *General American Investors Co. v. Commissioner,* 348 U.S. 434 (1955), which involved a payment of so-called "inside profits," made to a corporation by one of its officers, required by sec. 16(b) of the Securities Exchange Act. Under this provision, an officer who deals in the shares of his company under certain conditions is made liable to pay the profits over to the company. The taxpayer had received such payments in a substantial amount. These were held taxable as income. The Court said that the payments "were neither capital contributions nor gifts." It found "no indication that Congress intended to exempt them from coverage." It held the payments to be taxable "In accordance with the legislative design to reach all gain constitutionally taxable unless specifically excluded."

See Wright, "The Effect of the Source of Realized Benefits upon the Supreme Court's Concept of Taxable Receipts," 8 Stanford L.Rev. 164 (1956).

Compensation and Insurance for Injuries and Sickness—The "Sick Pay" Exclusion

With respect to damages or compensation for injuries or sickness, see **sec. 104** of the 1954 Code.[1] Cf. secs. 105 and 106. Is there a substantial loophole here?

Regulations have been issued under secs. 104, 105, and 106 as secs. 1.104–1 through 1.106–1 of the Income Tax Regulations.

EDWARD I. WEINROTH

Tax Court of the United States, 1959. 33 T.C. 58.

MULRONEY, JUDGE: Respondent determined a deficiency of $233.84 in petitioners' income tax for the year 1955. The sole question for decision is whether petitioners are entitled to a "sick pay" exclusion under section 105(d) of the Internal Revenue Code of 1954.[2]

All facts have been stipulated and they are found accordingly.

. . .

During the calendar year 1955 petitioner was employed as a teacher by the Board of Education of the City of New York. Under such employment petitioner was subject to the New York State Education Law and the bylaws of the board of education. Article I, section 2, paragraph 15 of the New York State Education Law is and was during the period here involved as follows:

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1 For discussion (under the predecessor of sec. 104), see Schlenger, "Disability Benefits under Section 22(b)(5)," 40 Va.L.Rev. 549 (1954). See also "Taxation of Employee Accident and Health Plans before and under the 1954 Code," 64 Yale L.J. 222 (1954).

2 All section references are to the Internal Revenue Code of 1954.

15. School year. The term "school year" means the period commencing on the first day of July in each year and ending on the thirtieth day of June next following.

Article X, section 90, paragraph 37 of the bylaws of the board of education is and was during the period here involved as follows:

37. The vacations and holidays allowed in the public schools shall be as follows: Every Saturday throughout the year; the 12th day of October; Election Day; the eleventh day of November; Thanksgiving Day and the day following; the 25th day of December to the 1st day of January and the intervening days; the 12th day of February; and the 22nd day of February; the day commonly known as Good Friday and the week following; the 30th day of May; the next day following any day above specified when such day shall be Sunday; in the Borough of Brooklyn, Anniversary Day; in the Borough of The Bronx, Borough Day; and the interval between the 30th day of June and the second Monday in September.

During the calendar year 1955 petitioner was assigned by the board of education to Abraham Lincoln High School, in Brooklyn, New York.

In June 1955, Gabriel R. Mason, then principal of Abraham Lincoln High School, requested petitioner to perform the following tasks:

(a) Revision of the lesson planning in General Science to conform with the projected new syllabus in that subject, and

(b) To review a number of text books in General Science for the purpose of selecting a book for use at Lincoln High School.

It was anticipated by Gabriel R. Mason and petitioner that such tasks would be performed and completed during July and August 1955. Gabriel R. Mason did not directly order petitioner to perform and complete such tasks during July and August 1955, but rather, petitioner agreed to comply with Gabriel R. Mason's request.

Gabriel R. Mason had no authority from the board of education or from the superintendent of schools to require a teacher to work during the months of July and August 1955, nor to assign a task or tasks during this period which, if performed, would deprive the teacher of his summer vacation. Likewise, the superintendent of schools had no authority from the board of education to require such work or to make such assignment during the calendar year 1955. Nothing contained in the New York State Educational Law or the bylaws of the board of education precluded petitioner from voluntarily complying with Gabriel R. Mason's request.

On July 1, 1955, petitioner began to perform the tasks requested but terminated such efforts on July 3, 1955, because of a

painful back condition. Petitioner was hospitalized for this painful back condition from July 5 to July 19, 1955, and he remained incapacitated during July and August 1955. He did not recover until September 9, 1955. Classes for the 1955–1956 school year began at Abraham Lincoln High School, as at all other New York City schools, on September 12, 1955, at which time petitioner reported for duty as a teacher.

The bylaws of the board of education provided that a teacher will be entitled to 10 days of sick leave with pay per year. Such unused sick leave may be accumulated up to a maximum of 200 days.

Pursuant to article IV, section 106(3) of the bylaws of the board of education a teacher would be charged with sick leave when absent from work during a school day, Monday through Friday. A teacher would not be charged with sick leave when sick on a Saturday, Sunday, legal holiday and/or Christmas, spring, or summer vacations.

Petitioner was not charged with any sick leave, either annual or accumulated, because of any sickness or injury sustained by petitioner during the period July 1 through September 9, 1955.

In his income tax return for 1955 petitioner excluded $914.28 from his gross income as "sick pay," because of his sickness during the period July 3 to September 9, 1955, and respondent, in the 90-day letter, disallowed this exclusion explaining "the amount of $914.28 has been disallowed as not deductible within the meaning of section 105(d) of the Internal Revenue Code of 1954."

Section 105(d) [2] allows an employee to exclude from gross income certain amounts which "constitute wages or payments in lieu of wages for a period during which the employee is absent

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2 SEC. 105. AMOUNTS RECEIVED UNDER ACCIDENT AND HEALTH PLANS.

(a) Amounts Attributable To Employer Contributions.—Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

* * * * * * * * * * * *

(d) Wage Continuation Plans.—Gross income does not include amounts referred to in subsection (a) if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness; but this subsection shall not apply to the extent that such amounts exceed a weekly rate of $100. In the case of a period during which the employee is absent from work on account of sickness, the preceding sentence shall not apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of sickness for at least one day during such period. If such amounts are not paid on the basis of a weekly pay period, the Secretary or his delegate shall by regulations prescribe the method of determining the weekly rate at which such amounts are paid.

from work on account of personal injuries or sickness." Petitioner reported receiving wages from the Board of Education of New York City in the total sum of $7,175.45 for the year 1955. His teaching contract is not in evidence and it is not specifically stipulated that petitioner received one-twelfth of his annual salary each month. However, petitioner pleaded that he was paid one-twelfth of his annual salary each month and, though respondent denied this in his answer, he now concedes on brief that petitioner was, pursuant to his employment contract, paid one-twelfth of his annual salary each month. We will assume petitioner received regular monthly salary payments during the period of his illness which it is stipulated extended from July 3 t~~o September 9, 1955.~~ The only question is whether he was "absent from work" during said period. It appears from the stipulation that the illness period was wholly within petitioner's normal vacation period: i. e., between the 30th day of June and the second Monday in September. The question comes down to whether petitioner was "absent from work" within the meaning of the statute when the period of the alleged absence on account of illness falls entirely within his vacation period.

The Commissioner, in his Income Tax Regulations, section 1.105–4(a)(3)(i), *et seq.,* issued under the 1954 Code, has stated:

> (i) Section 105(d) applies only to amounts attributable to periods during which the employee would be at work were it not for a personal injury or sickness. Thus, an employee is not absent from work if he is not expected to work . . .
>
> (ii) Similarly, an employee who incurs a personal injury or sickness during his paid vacation is not allowed to exclude under section 105(d) any of the vacation pay which he receives, since he is not absent from work on account of the personal injury or sickness. Likewise, a teacher who becomes sick during the summer or other vacation period when he is not expected to teach, is not entitled to any exclusion under section 105(d) for the summer or vacation period. However, if an employee who would otherwise be at work during a particular period is absent from work and his absence is in fact due to a personal injury or sickness, a payment which he receives for such period under a wage continuation plan is subject to section 105(d).
>
> (4) . . . the exclusion provided under section 105(d) is applicable only to . . . payments attributable to a period when the employee would have been at work but for such personal injury or sickness.

Petitioner does not attack these regulations as an unreasonable or arbitrary interpretation of section 105(d), but rather urges that they have no application to the present case because petitioner was "at work." We cannot agree.

Petitioner was paid at a yearly rate by the board of education to teach school. His employer specifically provided in its by-laws that its teachers were to receive a summer vacation extending at least from June 30 to the second Monday in September. Petitioner was hired to, expected to, and required to teach school about 10 months out of the year. If he had done nothing during the months of July and August he would still have been entitled to the entire amount of his salary. The board of education did not expect or require that he work for it during his vacation. At the request of his principal he volunteered to undertake several projects directly connected with his job. The projects he undertook and the amount of time which it was expected he would spend on them in no way affected his annual salary or the periodic payment of it to him.

While the Commissioner, in his regulations, has stated that all circumstances must be taken into account[3] in determining whether the employee was absent from work and has ruled[4] that the manner in which the employee's absence is reflected on the employer's records is not determinative of the rights of the employee to the exclusion, yet we think it significant that the board of education did not charge petitioner with sick leave and thus evidently did not consider him at work for the period in question.

Petitioner was a volunteer doing "work" which he was not required to do, without extra compensation, during the time normally set aside for his vacation. Although we have no doubt that the projects he had undertaken may well have entailed both mental and physical effort, we must hold, on the record before us, that he cannot qualify for an exclusion under section 105(d) because he cannot be "absent from work" in a period which is not a working period for him.[5]

We sustain respondent upon the issue presented. Certain adjustments were not contested and certain adjustments were conceded by respondent. Accordingly,

Decision will be entered under Rule 50.

Note

See Pyle, "Accident and Sickness Insurance Under Code Sections 104, 105, 106, and 213," 34 Taxes 363 (1956). See also Rev.Rul. 58–602, 1958–2 Cum.Bull. 109, where it was ruled that premiums paid for a policy of insurance giving indemnity for

3 Income Tax Regs., sec. 1.105–4(a)(5).
4 Rev.Rul. 55–85, 1955–1 C.B. 15.
5 See Income Tax Regs., sec. 1.105–4(b).

medical bills are deductible under sec. 213, but that payments received under such policies are excludable from gross income to the extent provided in sec. 104.

Governmental Payments, Subsidies and Business Contributions

Gov't impounded receipts of gas & oil claims & by act [illegible] to those who had equitable claim & then the money accumulated from the gas & oil.

BURKE-DIVIDE OIL CO. v. NEAL

T/P cla[illegible] a gift

Circuit Court of Appeals, Seventh Circuit, 1934. 73 F.2d 857.

ALSCHULER, CIRCUIT JUDGE. The appeal is from a judgment denying appellant's demand for the recovery of $74,434.82, which it had paid under protest to the collector of internal revenue pursuant to a redetermination by the Commission of Internal Revenue of appellant's income tax for the calendar year 1926. Jury was waived, and the facts are all stipulated.

The sole question in the case is whether certain payments made to appellant by the Secretary of the Interior during the year 1926 were "gross income" to appellant under section 213(a) of the Revenue Act of 1926, or are to be regarded as a gift by the United States to the taxpayer, which under section 213(b) of the same act, would be excluded from "gross income."

It appears that in the years 1918 and 1919 appellant (which term as here employed refers as well to appellant's predecessors in interest, to whose rights appellant has concededly succeeded) located certain claims for oil and gas in the bed of the Red river, assumed to be the boundary line between the states of Texas and Oklahoma. The locations were concededly made in good faith, on the assumption that they were in compliance with the mining laws of the United States and upon lands of the United States which were subject to such location. Appellant expended not less than $107,000 in development work upon the claims.

Contention arose between the states of Texas and Oklahoma as to which of these states included in its borders the disputed area upon which these mining claims, as well as others, had been located. Texas, which, unlike other states, held title to the public lands within its borders, claimed title to this area, and interfered with the work on these locations. Physical conflict between the authorities of the two states was threatened, when Oklahoma applied to the United States Supreme Court to take jurisdiction of and settle the boundary dispute. The Supreme Court took jurisdiction and appointed a receiver for all the lands in question, and the improvements thereon. The receiver took possession and under direction of the court operated the property, producing and disposing of the oil and gas therefrom—not only from wells which had been started by the locators, but also from wells drilled by the receiver upon these locations.

The United States, contending that it had title to the area, and that the locations thereon were unauthorized and void, filed its petition for intervention, which the court allowed. The locators of claims in the area, including appellant, also filed petitions to intervene, asserting their title to their respective locations, and were admitted as parties to the suit.

On May 1, 1922, the court decided that the area in question belonged to the United States, and that these locations were unauthorized by any law of the United States and conferred no lawful rights on the several locators, and that the locations were void; and decree was entered accordingly. *State of Oklahoma v. State of Texas,* 258 U.S. 574, pages 582, 599–602.

The operation of the property by the receiver had resulted in the accumulation of income aggregating upwards of $5,000,000, which had been impounded by order of the court awaiting the outcome of the litigation and the order of the Supreme Court for disposition of the impounded fund. After this decision of the Supreme Court, Congress passed the Act of March 4, 1923. Section 1[1] of the act authorizes the Secretary of the Interior to adjust the "equitable claims" of those who in good faith prior to February 25, 1920, had made locations upon these lands in an effort to develop oil or gas, by issuing permits or leases to those found equitably entitled thereto.

In other sections of the act terms of such leases are set forth and provisions made for the granting of permits and leases upon these lands, and the disposition of the impounded fund resulting from the receiver's operation of the properties. Various deductions therefrom are provided for, including 12½ per cent. as royalty to the United States; and it was specified that "the balance after deducting the expense of collection shall be paid over to the person or persons awarded permits or leases under this Act, as their interests may appear." Section 4.

Section 6 of the act specifies that the Supreme Court is authorized, on termination of the receivership, to direct the receiver to pay to the Secretary of the Interior the impounded fund, and that when the fund shall have been paid to the Secretary of the Interior it shall be by him administered and disbursed

[1] "Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Secretary of the Interior is hereby authorized to adjust and determine the equitable claims of citizens of the United States, and domestic corporations to lands and oil and gas deposits belonging to the United States and situated south of the medial line of the main channel of Red River, Oklahoma, which lands were claimed and possessed in good faith by such citizens or corporations, or their predecessors in interest, prior to February 25, 1920, and upon which lands expenditures were made in good faith and with reasonable diligence in an effort to discover or develop oil or gas, by issuance of permits or leases to those found equitably entitled thereto." 42 Stat. 1448.

as in the act provided. The Secretary was authorized by section 7 to prescribe the necessary rules and regulations and to do all things necessary to carry out the purpose of the act.

After the act was passed, and in pursuance of it, appellant made aplication for permits and leases thereunder of the lands whereon its locations had previously been made. The Secretary of the Interior held hearings and decided that appellant had equitable claim to the lands and oil and gas deposits for which its application had been made; and in 1925 he granted appellant a permit to prospect on these lands for oil and gas. Later, in pursuance of the terms of the Act of March 4, 1923, and the regulations promulgated thereunder, the Secretary leased to appellant the lands it had located.

On April 19, 1926, the Secretary of the Interior, acting under the authority of the Act of March 4, 1923, paid over to appellant the sum of \$762,320.37, as the share of the receiver's operating income attributable to the properties whereon appellant's locations had been made, less receivership and other authorized expense, including 12½ per cent. royalty to the United States.

There is no conflict, as appellant seems to contend, between the decision of the Supreme Court and the Act of March 4, 1923. When the court decided that the lands and the income therefrom belonged to the United States, the power of disposal over the lands and the proceeds was with the United States through the Congress; and the Supreme Court, in compliance with the Act of Congress of March 4, 1923, passed to that end, ordered the receiver to turn the fund over to the Secretary of the Interior, which was done.

The transaction between appellant and the United States, through its Secretary of the Interior, involved not merely the turning over of this sum of money to appellant. The payment of the money was but one feature of the transaction. Had the leases not been made to appellant the funds would not have been paid to it; but since the act provides that the money may be paid over only to those who establish equitable claims to the lands, and to whom the leases were accordingly made, such lessees could not be other than persons who, like appellant, had in good faith located and worked the claims in the search for and production of oil and gas. The terms upon which the new leases might be granted were such as were within the limitations prescribed by the act and approved by the Secretary of the Interior. They included an undertaking to operate, and continue to operate, the properties, and to pay the United States royalty of 12½ per cent. upon the production. The act provides that the impounded fund be paid only to those found equitably entitled to receive the permits or leases, and who would accept and enter into them.

We read in this transaction mutual undertakings of the parties from which it cannot be concluded that the payment of the money was wholly without any consideration to the United States, and merely by way of gratuity or gift to the ultimate recipients of the fund. Whether or not the United States might have made more profitable disposition of the lands and the fund is here of no materiality. . . .

Had the revenue arising from operation of these locations been received by appellant during the time it possessed and operated them, unquestionably such revenue would have been includible in its taxable gross income. We think it was none the less so includible if, as was here the case, it reached the taxpayer indirectly through being first impounded in the registry of the court and later turned over by the court to the representative of the United States, who, under proper authority, and recognizing appellant's equitable claim to the fund, paid it over to appellant as and for its own.

To qualify itself under the statute for taking the lease and receiving the money, appellant asserted and maintained its equitable right thereto; but now that the money has been safely secured, its inclusion in taxable income is resisted on the ground that it was purely a gift from the United States to appellant. Surely appellant cannot well complain if this incompatible contention does not meet with the concurrence of the Government or the courts.

The judgment is

Affirmed.

Notes

(A) In *Boston Elevated Ry. Co. v. Commissioner,* 131 F.2d 161 (C.C.A.1st, 1942), the railway was operated under a Public Control Act, passed in 1918. Under this Act, the Commonwealth guaranteed the dividends of the company. Any deficit in revenues had to be made up by the Commonwealth, and any surplus above the cost of service and dividends was paid to the Commonwealth. The court held that amounts paid to the company to make up deficits were not loans, but were taxable as income. See also *United States v. Maryland Jockey Club,* 210 F.2d 367 (C.A.4th, 1954) cert. den. 347 U.S. 1014 (1954); *Southern Maryland Agricultural Ass'n v. United States,* 227 F.2d 200 (C.A. 4th, 1955), and the sequel to the latter case in *Southern Maryland Agricultural Ass'n v. United States,* 137 Ct.Cls. 176, 147 F.Supp. 276 (1957).

(B) Payments to farmers under the Soil Conservation Act, and related legislation, have been held taxable, *Baboquivari Cattle Co. v. Commissioner,* 135 F.2d 114 (C.C.A.9th, 1943); Rev. Rul. 60–32, 1960–1 Cum.Bull. ——.

(C) See, generally, Fletcher, "The Taxability of the Government Subsidy," 12 Geo.Wash.L.Rev. 245 (1944); Mandell, "Do Subsidies Constitute Taxable Income?" 26 Taxes 323 (1948).

TELESERVICE CO. OF WYOMING VALLEY v. COMMISSIONER

United States Court of Appeals, Third Circuit, 1958. 254 F.2d 105.

KALODNER, CIRCUIT JUDGE.

Were "contributions" received by the taxpayer, a television signal transmission service, from its customers, "toward the total cost of constructing" its facilities, under a contract which simultaneously provided for such "contributions" and the further payment of a "monthly maintenance charge", includable as "gross income" under Section 22(a) of the Internal Revenue Code of 1939?

That is the issue presented by this petition for review of the decision of the Tax Court which answered it affirmatively, thereby making the "contributions" toward the cost of construction taxable as gross income. The Tax Court's decision was premised on its "Ultimate Finding" that the "contributions" to the taxpayer "* * * were not gifts or contributions to capital; they were part of the payment for services rendered or to be rendered by the petitioner [taxpayer] and are includable in petitioner's [taxpayer's] gross income."

It must immediately be noted that the "Ultimate Finding" of the Tax Court "* * * was in the nature of an ultimate finding of fact and since such finding is but a legal inference from other facts it is subject to review free of the restraining impact of the so-called 'clearly erroneous' rule applicable to ordinary findings of fact by the trial court * * *." [3]

The facts may be summarized as follows:

Teleservice Company of Wyoming Valley ("taxpayer") is a Pennsylvania corporation. It promoted, constructed and now operates for profit a community antenna television system at Wilkes-Barre and Kingston, Pennsylvania.

The residents of Wilkes-Barre and Kingston were unable by conventional television roof-top or built-in antennas to receive television signals of an adequate visual quality due to the fact that the cities are located in valleys surrounded by hills which effectively screened or cut off television signals which would otherwise be available for reception by conventional methods. Therefore, in January, 1951, the taxpayer's incorporators determined that a company should be organized for the purpose of providing television signals to the residents of the Wilkes-Barre area through a community television system.

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3 Philber Equipment Corporation v. Commissioner, 3 Cir., 1956, 237 F.2d 129, 131.

In 1951 no licenses for Ultra High Frequency (U.H.F.) television stations (to provide a local, conventional television service to the area) had then been issued, but there were indications that such licenses would be granted in the near future, and it was known that at least one company in Wilkes-Barre would make application for such license. This created a hazard to investment of money in the enterprise contemplated by the taxpayer. In addition, taxpayer's founders determined that the construction of a community antenna system was an unknown business with no adequate precedent to follow and without definite information available on past experience.

Two community antenna systems were investigated—one in Lansford, Pennsylvania, which was observed in operation, and another in Pottsville, Pennsylvania, which was in the process of being constructed. The taxpayer was the third company of its type in existence.

After a study of some six months, the taxpayer selected a suitable location for the interception of television signals on top of the mountain range surrounding Wilkes-Barre and Kingston. It found that it would be necessary to run a trunk line of coaxial cables from the location selected to the edge of the populated area on the fringe of Wilkes-Barre, a distance of about five miles, before any significant service could be offered. This "dead" trunk line was not found in the other systems studied; it would be costly, and taxpayer was not certain it would be a success. The Radio Corporation of America (R.C.A.) provided engineers to make a survey of the projected system, and furnished estimates of the cost of the equipment and materials that would be required. On the basis of the experience of the two other community antenna systems and the advice received from R.C.A. it was estimated that it would cost 96 cents per foot for the trunk line cable or feeder line cable to be installed and erected. This cost tended to be constant, regardless of the size of the system, since the only fixed cost was that of constructing the antenna tower atop the mountains which was relatively small—$1,500 to $3,000. It was calculated that the cost of constructing a system to serve Wilkes-Barre and Kingston would be as much as $250,000.

Before construction was begun or money paid into its treasury by its founders, the taxpayer decided that construction of the system would have to be financed essentially through contributions from prospective customers or subscribers since it would be too great a risk for it to undertake the entire investment and that, in any event, it would be impossible for it to realize a profit should it do so. It determined that whatever profit it might realize from the venture would come from monthly service charges.

Under the program formulated by the taxpayer contributors were divided into two classes—residential and commercial. The residential customers were to be required to make contributions of $145.00; the commercial customers $200.00. These varying scales were fixed by the taxpayer because, although service installation costs were the same with respect to both classes of customers, it believed that the commercial establishments could afford to contribute a greater amount than could a private individual. In fixing the amount of the contributions to be made by customers the taxpayer took into consideration its estimated construction costs and amounts solicited by other community systems. In this connection taxpayer estimated that the contributions, if it obtained the number of customers anticipated, would just about balance the costs of construction of its entire system.

The taxpayer's program also provided that residential customers were to pay $4.00 monthly and commercial customers $6.00 monthly as a service or maintenance charge in addition to their initial contributions. The monthly charges were designed to cover the maintenance of the community system and included an element of profit to the taxpayer. The rates were not set by any regulatory commission.

The taxpayer's system was constructed in several distinct stages. The first step was the erection of a tower and intercepting antennas and the installation of a main trunk line cable, approximately five miles in length, to the first distribution area. The cost of this first stage, $24,138.49, was advanced by the taxpayer's incorporators.

On completion of this first step potential subscribers were solicited. When a sufficient number of applications for service had been received to indicate that further extension of the system would be feasible the taxpayer entered into contracts with subscribers and then proceeded with construction in the area in which they were located. Six months elapsed after completion of the initial construction before the first extension of the system was undertaken. Thereafter, the delay between extensions was substantially reduced.

Upon acceptance of an area for the extension of service, taxpayer entered into contracts with the subscribers. Taxpayer agreed "to furnish subscriber at the place of installation * * * a television signal transmission service". The subscriber, in turn, agreed (1) to contribute the sum specified "toward the total cost of constructing a system for the transmission of a television signal" and (2) to pay "a monthly maintenance" charge which would entitle him to receive service. While a contribution was a prerequisite to eligibility to use of the system, it did not entitle the contributor to receive television signals. The contributor was

required to make monthly payments, in advance, in order to receive the signals. Potential subscribers were advised that the contribution was in aid of construction of the facility for supplying the television signals, and had no bearing on the service, which would be charged as an extra item.

A contributor could not sell, assign, or transfer his eligibility to receive television signals, but he remained eligible to receive the signals without additional cost if he moved to another part of Wilkes-Barre or Kingston. However, the person who moved into the contributor's old home was required to make a contribution in order to become eligible to use the system.

The contract between taxpayer and its customers specified that it was subject to "General Provisions." The latter in turn provided, inter alia: (1) if the taxpayer by reason of its public utility contracts or governmental action found it "* * * either impossible or impractical * * * to furnish television transmission service under this contract * * *" it had the right to terminate the contract and in such event "* * * *all contributions, maintenance rates, and other moneys paid* * * * *by Subscriber* [*to it*] *shall be forfeited*"; (2) taxpayer could terminate its contract with the subscriber in the event of the latter's violation and that in such event "* * * Subscriber shall not be entitled to a refund of any kind * * *"; and (3) if taxpayer terminated the contract for its convenience "* * * Subscriber *shall be refunded a part of his contribution money,* as follows: A maximum of Sixty (60) Dollars less Ten (10) Dollars for each month this contract has been in effect * * *". (emphasis supplied)

No change was ever made in the $4.00 monthly charge for maintenance in the case of a residence, or in the $6.00 monthly charge in the case of a commercial establishment. Also, the $200.00 contribution required of commercial establishments was never changed. However, the amount required of residential subscribers was reduced to $89.00 on January 1, 1953; to $80.00 on June 1, 1954; to $30.00 in August, 1955, and no contributions have been required since 1956.

The greatest number of connections in operation at one time was about 900 and the least was about 200 to 300. In 1956 there were about 400 connections in operation. The decrease in connections resulted in 1952 when U.H.F. licenses were granted to local television stations in Wilkes-Barre and Scranton, Pennsylvania. The number of contributions also fell off sharply at that time.

During the period February 20, 1951, to January 31, 1952, the first tax year here involved, taxpayer received under contracts "contributions" totalling $27,601.98; during the same period construction costs of the system totalled $62,880.64.

During the period February 1, 1952, to January 31, 1953, the second tax year here involved, taxpayer received under contracts "contributions" totalling $88,544.79; during this period construction costs of the system totalled $70,620.78.

As reflected by the foregoing, the total cost of constructing the system amounted to $133,501.42 of which sum $116,146.77 was paid for by the "contributions" and the balance of $17,354.65 was financed with borrowed money. All of the funds received as "contributions" were applied to construction costs. Taxpayer's operating expenses were paid from sums collected from subscribers as monthly payments for maintenance and operation, under the terms of their contracts.

All initial payments received by the taxpayer were credited to an account maintained in its books and records called "Customer Contributions". Segregation of the funds paid as contributions was maintained on the books of the taxpayer, as against sums received from monthly maintenance charges. All funds were deposited in the taxpayer's general bank account from which were paid general operating expenses and the cost of all assets acquired. However, the taxpayer's accounting system segregated the costs of construction and the amounts received as contributions. The amounts received as contributions were never applied by the taxpayer to any of the expenses normally chargeable to operation. Only the monthly service charges were employed for such expenses.

Taxpayer in filing its income tax returns did not include the contributions from subscribers in its gross income. Further, it did not claim deductions upon its income tax returns for depreciation of the physical facilities of the community antenna television system but showed the accounting depreciation as a non-deductible item.

The Commissioner treated the contributions as gross income during the taxable years involved and determined a deficiency accordingly. In such determination he, however, allowed the taxpayer a deduction for depreciation of the physical assets of its system purchased with the contributions. The Commissioner's determination resulted in the tax deficiencies here in issue—$3,210.83 for the year ended January 31, 1952, and $13,013.09 for the year ended January 31, 1953.

Taxpayer unsuccessfully petitioned the Tax Court for redetermination of the deficiencies asserted by the Commissioner. It may be noted parenthetically that the Tax Court's decision was "Reviewed by the Court" and that one judge dissented.

Sketched in sweeping outline the contentions of the taxpayer and the Government may thus be stated:

Taxpayer urges that the contributions received from subscribers here were "in aid of capital construction" and thus did not constitute "income" under what it characterizes as the basic teaching of the "doctrine" of *Edwards v. Cuba Railroad Co.,* 1925, 268 U.S. 628.

The Government asserts (1) the Internal Revenue Code of 1939 accords no tax exemption for "contributions in aid of capital construction"; (2) only payments which are made in the nature of gifts or capital contributions are excludable from gross income; (3) payments in aid of construction which are made in return for services rendered or to be rendered are not gifts or capital contributions and (4) the so-called "contributions" made by subscribers here actually constituted part of the price of the services to be rendered by the taxpayer. In support the Government cites *Detroit Edison Co. v. Commissioner,* 1943, 319 U.S. 98.

The parties agree, as did the Tax Court, that *Edwards v. Cuba Railroad Co., supra,* was followed by the Tax Court (and its predecessor Board of Tax Appeals) for some thirty years until the decision now under review.

The Tax Court in its opinion declared that it was compelled to the conclusion it reached under *Detroit Edison Co. v. Commissioner, supra,* and the doctrine of *Commissioner v. Glenshaw Glass Co.,* 1955, 348 U.S. 426, and *General American Investors Co. v. Commissioner,* 1955, 348 U.S. 434. It conceded, that apart from *Edwards v. Cuba Railroad,* supra, which it distinguished factually, it was unable to make similar distinction with respect to its own prior application of the *Edwards* decision in numerous cases. With respect to the latter it frankly stated (27 T.C. at page 729):

> "In spite of the sheer weight in number of those decisions, we feel bound to make an ultimate finding consistent with that of the *Detroit Edison* case, and what in our view appears to be a gradually but persistently broadening concept of taxable income as exemplified by the *Glenshaw Glass Co.* and *General Investors Co.* cases, supra." . . .

Upon consideration of the record and the contentions of the parties as to the ultimate finding of fact to be made from the undisputed basic facts we are of the opinion that the Tax Court's ultimate finding that the initial payments made by the taxpayer's customers "* * * were not gifts or contributions to capital", but "* * * were part of the payment for services rendered or to be rendered" by the taxpayer, was amply sustained by the record and that the Tax Court correctly ruled the initial payments to be includable in the taxpayer's gross income under Section 22 (a) of the Internal Revenue Code of 1939.

Detroit Edison Co. v. Commissioner, supra, is an illuminating guide to our determination, although it is true, as the taxpayer urges, that the Supreme Court did not, nor was it required to, there decide the precise issue here presented.

In *Detroit Edison* the taxpayer claimed depreciation on certain extensions of its lines paid for by prospective customers as a prerequisite to obtaining service and treated by the taxpayer as contributions to capital. The payments made by the customers never exceeded and sometimes fell short of the actual cost of the facilities. They were not included in taxpayer's gross income in its tax returns.

In holding that the Detroit Edison Company did not acquire a substituted basis for depreciation by virtue of its receipt of estimated construction costs from applicants for its services the Supreme Court said (319 U.S. at pages 102, 103):

> "The Company, however, seeks to avoid this result by the contention that what it has obtained are gifts to it or contributions to its capital of the property paid for by the customer, and that therefore by the provisions of § 113(a) (2) and (8) (B) it takes the basis of the donor or transferor. *It is enough to say that it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company. The transactions neither in form nor in substance bore such a semblance.*
>
> *"The payments were to the customer the price of the service * * *".* (emphasis supplied)

We are unable to discern any substantial factual distinction between the initial payments made by the taxpayer's customers in the instant case and the payments made by the customers in *Detroit Edison.* In each case the payments were made as a prerequisite to obtaining direct personal service via the construction of facilities which would provide such service; in each instance the payments were not for a community or public benefit, as in *Brown Shoe Co. v. Commissioner,* 1950, 339 U.S. 583, and in *Commissioner v. McKay Products Corp.,* 3 Cir., 1949, 178 F.2d 639, 641, where the payments were made to the taxpayer by a community group to promote communal interests, and were for that reason held to be "contributions to capital" meriting depreciation allowance under applicable revenue laws. . . .

Analysis of the substance rather than the semblance of the relationship existing between the taxpayer and its customers in the light of the principle that "taxation is an intensely practical matter" inescapably discloses that the relationship was that of seller-customer.

The communal aspects of the enterprise, urged by the taxpayer, are entirely lacking in significance. The initial payment made by a customer was the admission price which he paid for his individual enjoyment of the taxpayer's facilities and in no sense could it be regarded as a contribution to community participation. Only he who bought a ticket could "go for the ride". The pioneer and hazardous nature of the enterprise and the circumstance that the capital facilities had no salvage value, heavily stressed by the taxpayer, are of no critical value with respect to the issue here involved. . . .

The Supreme Court, in *Commissioner v. Glenshaw Glass Co.*, 1955, 348 U.S. 426, *General American Investors Co. v. Commissioner*, 1955, 348 U.S. 434, *Commissioner v. LoBue*, 1956, 351 U.S. 243, at page 246, has, as it stated in the latter case "* * * repeatedly held that in defining 'gross income' as broadly as it did in § 22(a) Congress intended to 'tax all gains except those specifically exempted' ". In *Robertson v. United States*, 1952, 343 U.S. 711, 714, it was specifically held that "Where the payment is in return for services rendered, * * * " such payment is gross income under § 22(a).

There remains but this to be said. Taxpayer urges that Congress has now ~~specifically recognized,~~ by the enactment of Section 118(a) of the Internal Revenue Code of 1954 that gross income does not include any contribution to the capital of a company. Our agreement with the Tax Court's ultimate finding that the initial payments here were "part of the payment for services rendered or to be rendered" and not as capital contributions makes unnecessary any discussion of that contention. However, we must point out that the Committee Reports [7] accompanying Sections 118 and 362 [8] of the 1954 Code (also cited by taxpayer) make it clear these provisions are not applicable to contributions or other payments by persons who are direct beneficiaries of the service rendered by the recipient corporation.

For the reasons stated the decision of the Tax Court will be affirmed.[9]

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[7] H.R. No. 1337, 83d Cong., 2d Sess. 17 (1954); Sen.Rep. No. 1662, 83d Cong., 2d Sess. 18 (1954).

[8] Sen.Rep. No. 1662, 83d Cong., 2d Sess. 271–272 (1954).

[9] It merits observation that in his excellent Note—Contributions to Capital by Non-shareholders, 3 Tax L.Rev. 568, 573 (1948), Joseph O'Meara, Jr., then lecturer on Federal Taxation, University of Cincinnati, College of Law, concluded with this statement:

"Detroit Edison accordingly appears to foreshadow a contraction of the area in which Cuba Railroad will be followed in the future; it suggests that a payment will not be considered a contribution to capital if exacted from a prospective customer as a prerequisite to doing business with him."

Notes

(A) The *Detroit Edison* and *Brown Shoe* cases, referred to in the principal case, both involved deductions for depreciation of the property received or acquired. They are summarized at page 418 below.

(B) In the *Cuba Railroad* case, referred to in the principal case, a railroad company received payments from the Cuban government in connection with the construction of a line of railroad in Cuba. The company built the railroad, and was the owner of it; but the government paid it so much a mile as the work progressed pursuant to an offer which was designed to get some one to build the railroad. It was held that this was not taxable income. As the principal case indicates, later cases have narrowed the scope of this decision. See also *Texas & Pacific Ry. Co. v. United States,* 286 U.S. 285 (1933); *Commissioner v. Gillette Motor Transport, Inc.,* —— U.S. —— (1960).

(C) How far is this question now affected (in the case of corporations) ~~by sec.~~ 118(a) of the 1954 Code—new in ~~that Code~~? Cf. the provisions of sec. 362(c) of the 1954 Code, making it plain that a contribution to capital may be made by a non-shareholder. Since sec. 362(c) now disallows a depreciation deduction in all such cases, does it follow that the amounts received in all such cases are never income, by force of the statute?

(D) See Freeman and Speiller, "Tax Consequences of Subsidies to Induce Business Location," 9 Tax L.Rev. 255 (1954); Tax Consequences of Non-Shareholder Contributions to Corporate Capital," 66 Yale L.J. 1085 (1957), based on the Tax Court decision in the *Teleservice* case.

Income or Bequest

BANK OF NEW YORK v. HELVERING

Circuit Court of Appeals, Second Circuit, 1943. 132 F.2d 773.

L. HAND, CIRCUIT JUDGE. The executors of Demarest appeal from an order of the Tax Court, assessing a deficiency against them upon their testator's income tax for a part of the year 1937: i. e., for the period between January 1 and July 11, the day on which the testator died. At the time of his death Demarest had qualified and he and one, Hotaling, were acting as executors of Jennie E. Read, who had died in New York on February 22, 1936, and upon whose will letters testamentary were issued to them on April 6, 1936. For the purposes of this case the important words of the will were as follows: "I direct that each of them so specifically named above by me as executors and trustees shall receive, and I give to each of them in lieu of statutory commissions for his services five percent (5%) of the principal of my estate and five percent (5%) each year upon the income." If either or both ~~should die before her, or should~~ "fail to qualify, or resign or be removed or die before completing either as executors or trustees

the administration of my Will and trusts thereunder," the testatrix appointed a bank as substitute, and directed that it should receive only statutory commissions. At the time of the execution of the will—June 4, 1934—Demarest was over 70 years old, Hotaling was 77. While Demarest lived he received as executor and trustee within the period mentioned, over $81,000, and after his death his executors collected $8,000 more, making nearly $90,000 in all: five percent of the estate. His executors included in his gross income for 1937 two-fifths of this sum, two percent being the statutory commission allowed by the New York statute; they regarded the remaining three percent as a legacy and as not taxable for that reason. The Commissioner assessed a deficiency upon this three percent on the theory that the whole five percent was "compensation for personal service" under § 22(a) of the Revenue Act of 1936, 26 U.S.C.A. Int.Rev.Acts, page 825; and the Tax Court affirmed his ruling.

In *United States v. Merriam,* 263 U.S. 179, a wealthy testator bequeathed to six persons by the eleventh article of his will, legacies; two of $500,000, one of $250,000, two of $200,000; and by the sixteenth article he appointed the legatees his executors and trustees, and concluded as follows: "The bequests herein made to my said executors are in lieu of all compensation or commissions to which they would otherwise be entitled as executors or trustees." Both the district court—275 F. 109, 110—and the Supreme Court (though not this court—282 F. 851) assumed that, although the executors were obliged in good faith to qualify in order to become entitled to the legacies, they needed to do no more. In the district court I had thought that the legacies were within the statutory phrase, "compensation for personal service," because the testator had bequeathed them to some extent—"in part, anyway"—as compensation for services which he expected the executors to render; but the Supreme Court held that the test was, not whether the testator gave the legacies for services, but whether the legatees had to perform the services in order to earn the bequests. This result apparently did not depend upon the fact that the legacies were bequests *eo nomine,* that they were in a separate and earlier article of the will, and that they were of unequal amounts. The last factor could scarcely have been controlling, because the court apparently thought that no part of the bequests were taxable. Moreover, it is possible that the testator might have rated his executors' services at different values, or have expected them to give different amounts of time to their duties.

In *Ream v. Bowers,* 2 Cir., 22 F.2d 465, we came to an opposite conclusion, where the relevant provision of the will was: "I direct that my executors shall each be paid and shall each receive in full payment for all commissions, percentages, and

allowances by statute or otherwise, for acting as executors of this my will, the sum of fifty thousand dollars." We held (22 F.2d at 468) that "the direction * * * to pay $50,000 to each executor 'for acting' as such contemplated payment for rendering the entire service." Judge Sibley in the district court followed that decision in a case where the will read: "For his compensation as executor and trustee under this will, I give and bequeath to my son * * * twenty-five thousand dollars, which shall be in full for all services as executor and trustee." *Grant v. Rose*, D.C., 24 F.2d 115, 116. See also *Murray v. Commissioner of Internal Revenue*, 38 B.T.A. 26. We cannot follow the Tax Court in depending upon the form of the will: that is, that there was no independent and separate bequest; on the other hand, we own that the phrase: "I give to each of them in lieu of statutory commissions for his services five percent (5%)," is very close to the phrase in *Ream v. Bowers, supra:* "I direct that my executors shall each be paid * * * in full payment for all commissions * * * for acting as executors." We allocate the words: "for his services," to the words: "I give to each of them," as though the phrase read: "I give to each of them for his services in lieu of statutory commissions"; that is, we do not understand the testator to have used the words: "statutory commissions for his services," as a unitary phrase. Therefore, except for the fact that the executors were so old, that the legacies were "in lieu of" both executors' and trustees' commissions, and that the trusts were to run for the lives of young people, we might have held that they were given as "compensation for personal service" within § 22(a). But it is a cardinal canon of testamentary, as well as of any other documentary, interpretation that words shall be read in their setting, and the controlling facts here appear to us to be: first, what we have already mentioned, the age of the legatees and the expected duration of the trusts; and, second, that the testatrix in her will mentioned as an apparent reason for their appointment that they had already acted as executors of her husband. On the whole we are therefore disposed to read the will as not disturbing the usual result that such provisions require no more of the executor than qualifying. It is perhaps unnecessary to add that we have assumed with The Tax Court that *United States v. Merriam, supra,* still governs such situations; if it is to be overruled, the Supreme Court, not we, must overrule it.

Order reversed; deficiency expunged.

Problem

Was the amount paid to the executors within the deduction for "administration expenses" in computing the estate tax?

LYETH v. HOEY

Supreme Court of the United States, 1938. 305 U.S. 188.

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

The question presented is whether property received by petitioner from the estate of a decedent in compromise of his claim as an heir is taxable as income under the Revenue Act of 1932.

Petitioner is a grandson of Mary B. Longyear who died in 1931, a resident of Massachusets, leaving as her heirs four surviving children and the petitioner and his brother, who were sons of a deceased daughter. By her will, the decedent gave to her heirs certain small legacies and the entire residuary estate, amounting to more than $3,000,000, was bequeathed to trustees of a so-called Endowment Trust, created April 5, 1926, the income from which was payable to another set of trustees under another trust described as the Longyear Foundation. The main purpose of the latter trust was to preserve "the records of the earthly life of Mary Baker Eddy," the founder of the Christian Science religion.

When the will was offered for probate in Massachusetts there was objection by the heirs upon the grounds, among others, of lack of testamentary capacity and undue influence. After hearing, at which a statement was made by the respective parties of their proposed evidence, the probate court granted a motion for the framing of issues for trial before a jury. In that situation a compromise agreement was entered into between the heirs, the legatees, the devisees and the executors under the will, and the Attorney General of Massachusetts. This agreement provided that the will should be admitted to probate and letters testamentary issued; that the specific and pecuniary bequests to individuals should be enforced; that the bequest of the residuary estate to the Endowment Trust should be disregarded; that $200,000 should be paid to the heirs and a like amount to the Endowment Trust, and that the net residue of the estate, as defined, should be equally divided between the trustees of the Endowment Trust and the heirs. The net residue to which the heirs were thus entitled was to be payable in units of stock owned by the decedent in certain corporations, Longyear Estate, Inc., Longyear Corporation and Longyear Realty Corporation, and for that purpose a unit was to consist of three shares, one share of each corporation.

The compromise was approved by the probate court pursuant to a statute of Massachusetts (Mass.Gen.Laws 1932, Chap. 204, Secs. 15–17) and a decree was entered on April 26, 1932, admitting the will to probate, issuing letters testamentary to the executors and directing them "to administer the estate of said deceased in accordance with the terms of said will and said agreement of compromise." Owing to the depression and the neces-

sity of discharging pecuniary legacies amounting to above $300,000, which were entitled to priority in payment before distribution of the residue, the heirs undertook to finance one-half of these legacies and the residuary legatees the other one-half. For this purpose the heirs formed a corporation known as Longyear Heirs, Inc., to which they assigned their interests in the estate in exchange for common stock. Preferred stock was issued to the pecuniary legatees.

In July, 1933, the executors distributed to Longyear Heirs, Inc., as assignee of the petitioner, his distributable share of the estate consisting of $80.17 in cash and a certificate of deposit for 358 units, each unit representing one share of each of the three corporations mentioned in the compromise agreement. The Commissioner of Internal Revenue valued this distributable share at $141,484.03 and treated the whole amount as income for the year 1933 in which it was received. An additional tax of $56,389.65 was assessed which petitioner paid in October, 1936, with interest. Claim for refund was then filed and on its rejection this suit was brought against the collector.

On motion of petitioner the District Court entered a summary judgment in his favor (20 F.Supp. 619) which the Circuit Court of Appeals reversed. 96 F.2d 141. Because of a conflict with the decision of the Circuit Court of Appeals of the Fourth Circuit in *Magruder v. Sagebade,* 94 F.2d 177, certiorari was granted.

The Court of Appeals overruled the contentions of petitioner that the property he received was within the statutory exemption (Section 22(b)(3) of the Revenue Act of 1932) and, further, that the property was not income either under the statute or under the Sixteenth Amendment of the Federal Constitution. As the view of the Court of Appeals upon these questions determined the rights of the parties, it was found unnecessary to discuss certain affirmative defenses set up by the answer of the respondent and these defenses are not pressed in this court.

First.—By Section 22(b)(3) of the Revenue Act of 1932, there is exempted from the income tax—

"The value of property acquired by gift, bequest, devise, or inheritance. . . ."

Whether property received by an heir from the estate of his ancestor is acquired by inheritance, when it is distributed under an agreement settling a contest by the heir of the validity of the decedent's will, is a question upon which state courts have differed. The question has arisen in the application of state laws of taxation. In Massachusetts, the rule is that when a will is admitted to probate under a compromise agreement, the state succession tax is applied to the property "that passes by the

terms of the will as written and not as changed by any agreement for compromise." *Baxter v. Treasurer,* 209 Mass. 459, 463. . . .

In the instant case, the Court of Appeals applied the Massachusetts rule, holding that whether the property was received by way of inheritance depended "upon the law of the jurisdiction under which this taxpayer received it." We think that this ruling was erroneous. The question as to the construction of the exemption in the federal statute is not determined by local law. We are not concerned with the peculiarities and special incidences of state taxes or with the policies they reflect. Undoubtedly the state law determines what persons are qualified to inherit property within the jurisdiction. *Mager v. Grima,* 8 How. 490, 493; *Maxwell v. Bugbee,* 250 U.S. 525, 536, 537. The local law determines the right to make a testamentary disposition of such property and the conditions essential to the validity of wills, and the state courts settle their construction. *Uterhart v. United States,* 240 U.S. 598, 603. The State establishes the procedure governing the probate of wills and the processes of administration. Petitioner's status as heir was thus determined by the law of Massachusetts. That law also regulated the procedure by which his rights as an heir could be vindicated. The state law authorized its courts to supervise the making of agreements compromising contests by heirs of the validity of an alleged will of their ancestor, in order that such compromises shall be just and reasonable with respect to all persons in interest. But when the contestant is an heir and a valid compromise agreement has been made and there is a distribution to the heir from the decedent's estate accordingly, the question whether what the heir has thus received has been "acquired by inheritance" within the meaning of the federal statute necessarily is a federal question. It is not determined by local characterization.

In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income and to grant exemptions from that tax, it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, should be interpreted "so as to give a uniform application to a nationwide scheme of taxation." *Burnet v. Harmel,* 287 U.S. 103, 110. Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law. *Burnet v. Harmel, supra.* See *Burk-Waggoner Association v. Hopkins,* 296 U.S. 110, 111, 114; *Weiss v. Wiener,* 279 U.S. 344, 356; *Morrissey v. Commissioner,* 296 U.S. 344, 356. Compare *Crooks v. Harrelson,* 282 U.S. 55, 59; *Poe v. Seaborn,* 282 U.S. 101, 109, 110; *Blair v. Commissioner,* 300 U.S. 5, 9, 10.

There is no such expression or necessary implication in this instance. Whether what an heir receives from the estate of his ancestor through the compromise of his contest of his ancestor's will should be regarded as within the exemption from the federal tax should not be decided in one way in the case of an heir in Pennsylvania or Minnesota and in another way in the case of an heir in Massachusetts or New York, according to the differing views of the state courts. We think that it was the intention of Congress in establishing this exemption to provide a uniform rule.

Second.—In exempting from the income tax the value of property acquired by "bequest, devise, or inheritance," Congress used comprehensive terms embracing all acquisitions in the devolution of a decedent's estate. For the word "descent," as used in the earlier acts,[1] Congress substituted the word "inheritance" in the 1926 act and the subsequent revenue acts as "more appropriately including both real and personal property."[2] Thus the acquisition by succession to a decedent's estate whether real or personal was embraced in the exemption. Further, by the "estate tax," Congress has imposed a tax upon the transfer of the entire net estate of every person dying after September 8, 1916, allowing such exemptions as it sees fit in arriving at the net estate. Congress has not indicated any intention to tax again the value of the property which legatees, devisees or heirs receive from the decedent's estate.

Petitioner was concededly an heir of his grandmother under the Massachusetts statute. It was by virtue of that heirship that he opposed probate of her alleged will which constituted an obstacle to the enforcement of his right. Save as heir he had no standing. Seeking to remove that obstacle, he asserted that the will was invalid because of want of testamentary capacity and undue influence. In accordance with local practice, he asked the probate court to frame these issues for a jury trial. It then became necessary for him to satisfy the court that the issues were substantial. Issues are not to be framed unless it appears from statements by counsel of expected evidence or otherwise that there is a "genuine question of fact supported by evidence of such a substantial nature as to afford ground for reasonable expectation of a result favorable to the party requesting the framing of issues." *Briggs v. Weston,* 2 N.E.(2d) 466; *Smith v. Patterson,* 286 Mass. 356. Petitioner satisfied that condition and the probate court directed the framing of jury issues. It was in that situation, facing a trial of the issue of the validity of the

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1 See Act of October 3, 1913, Chap. 16, Section II, 38 Stat. 167; Revenue Acts of 1918, 1921 and 1924, Section 213(b)(3).

2 Revenue Act of 1926, Section 213(b)(3); Acts of 1928 and 1932, Section 22(b)(3). Sen.Rep. No. 52, 69th Cong., 1st Sess., p. 20.

will, that the compromise was made by which the heirs, including the petitioner, were to receive certain portions of the decedent's estate.

There is no question that petitioner obtained that portion, upon the value of which he is sought to be taxed, because of his standing as an heir and of his claim in that capacity. It does not seem to be questioned that if the contest had been fought to a finish and petitioner had succeeded, the property which he would have received would have been exempt under the federal act. Nor is it questioned that if in any appropriate proceeding, instituted by him as heir, he had recovered judgment for a part of the estate, that part would have been acquired by inheritance within the meaning of the act. We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound, as it disregards the substance of the statutory exemption. It does so, because it disregards the heirship which underlay the compromise, the status which commanded that agreement and was recognized by it. While the will was admitted to probate, the decree also required the distribution of the estate in accordance with the compromise and, so far as the latter provided for distribution to the heirs, it overrode the will. So far as the will became effective under the agreement it was because of the heirs' consent and release and in consideration of the distribution they received by reason of their being heirs. Respondent agrees that the word "inheritance" as used in the federal statute is not solely applicable to cases of complete intestacy. The portion of the decedent's property which petitioner obtained under the compromise did not come to him through the testator's will. That portion he obtained because of his heirship and to that extent he took in spite of the will and as in case of intestacy. The fact that petitioner received less than the amount of his claim did not alter its nature or the quality of its recognition through the distribution which he did receive.

We are not convinced by the argument that petitioner had but "the expectations" of an heir and realized on a "bargaining position." He was heir in fact. Whether he would receive any property in that capacity depended upon the validity of his ancestor's will and the extent to which it would dispose of his ancestor's estate. When, by compromise and the decree enforcing it, that disposition was limited, what he got from the estate came to him because he was heir, the compromise serving to remove *pro tanto* the impediment to his inheritance. We are of the opinion that the exemption applies.

In this view we find it unnecessary to consider the other questions that have been discussed at the bar.

The judgment of the Circuit Court of Appeals is reversed and that of the District Court is affirmed.

It is so ordered.

Notes

(A) *Cf. Dumont's Estate v. Commissioner,* 150 F.2d 691 (C.C.A.3d, 1945), where a charity, claiming under an earlier will, obtained a settlement. It was held that the amount it got was based upon its claim, and that the amount paid to it was deductible in determining the decedent's estate tax liability.

(B) In *Hugh Coyne,* T.C.Memo., November 7, 1953, it appeared that the taxpayer had worked for many years for a man now dead. He filed suit against the man's estate saying that he had worked for less than proper wages because the man had promised to bequeath him $100,000. The claim was settled for $25,000. At the tax hearing, the taxpayer testified that he had received a fair salary, and sought to maintain the position that the settlement was simply on account of the decedent's promise to make a bequest. The court held the amount received was taxable, saying that the taxpayer should be bound by his statement in making the claim against the estate that he was entitled to more compensation for his services rendered to the decedent.

(C) A died, leaving a will by which he devised a ranch worth $700,000 to charity. B claimed that A had given him the ranch before A died. A's executors settled the claim by paying B $125,000. The court held that the amount received by B was income, distinguishing *Lyeth v. Hoey* on the ground that the money received was not "a part of the very thing claimed." *White v. Thomas,* 116 F.2d 147 (C.C.A.5th, 1940), cert. den. 313 U.S. 581 (1941), noted in 54 Harv.L.Rev. 1073 (1941).

(D) Suppose that a manufacturer, in connection with the fire insurance on its buildings takes out insurance against the loss of profits which would occur if its buildings should burn and its manufacturing operations interrupted until the building could be replaced. This is so-called "use and occupancy" insurance. After a fire, a taxpayer having such insurance receives a payment covering not only the value of the buildings destroyed, but also a substantial sum for loss of profits and to cover fixed charges and expenses continuing during the suspension of the business. Are these latter amounts taxable as income? *Miller v. Hocking Glass Co.,* 80 F.2d 436 (C.C.A.6th, 1935), cert. den. 298 U.S. 659 (1936); *Massilon-Cleveland-Akron Sign Co.,* 15 T.C. 79 (1950). See Merritt, "Taxation of Proceeds of Use and Occupancy, or Business Interruption, Insurance," 33 Taxes 430 (1955), supplemented in 36 Taxes 306 (1958); Lowrimore, "The Taxability of Use and Occupancy Insurance Proceeds," 19 Taxes 140 (1941); *Rex v. B. C. Fir and Cedar Lumber Co.,* [1932] A.C. 441, noted in 46 Harv.L.Rev. 855 (1933).

(E) For a consideration of related questions, see Cutler, "Taxation of the Proceeds of Litigation," 57 Col.L.Rev. 470 (1957); "Taxability of Judgments," 4 U.C.L.A.L.Rev. 447 (1957); Moss, "Taxation of Damages and Recoveries," 36 Taxes 273 (1958); Nordstrom, "Income Taxes and Personal Injury Awards," 19 Ohio St.L.J. 212 (1958).

Income or Capital

HORT v. COMMISSIONER

Supreme Court of the United States, 1941. 313 U.S. 28.

MR. JUSTICE MURPHY delivered the opinion of the Court.

We must determine whether the amount petitioner received as consideration for cancellation of a lease of realty in New York City was ordinary gross income as defined in § 22(a) of the Revenue Act of 1932 (47 Stat. 169, 178), and whether, in any event, petitioner sustained a loss through cancellation of the lease which is recognized in § 23(e) of the same Act (47 Stat. 169, 180).

Petitioner acquired the property, a lot and ten-story office building, by devise from his father in 1928. At the time he became owner, the premises were leased to a firm which had sublet the main floor to the Irving Trust Co. In 1927, five years before the head lease expired, the Irving Trust Co. and petitioner's father executed a contract in which the latter agreed to lease the main floor and basement to the former for a term of fifteen years at an annual rental of $25,000, the term to commence at the expiration of the head lease.

In 1933, the Irving Trust Co. found it unprofitable to maintain a branch in petitioner's building. After some negotiations, petitioner and the Trust Co. agreed to cancel the lease in consideration of a payment to petitioner of $140,000. Petitioner did not include this amount in gross income in his income tax return for 1933. On the contrary, he reported a loss of $21,494.75 on the theory that the amount he received as consideration for the cancellation was $21,494.75 less than the difference between the present value of the unmatured rental payments and the fair rental value of the main floor and basement for the unexpired term of the lease. He did not deduct this figure, however, because he reported other losses in excess of gross income.

The Commissioner included the entire $140,000 in gross income, disallowed the asserted loss, made certain other adjustments not material here, and assessed a deficiency. The Board of Tax Appeals affirmed. 39 B.T.A. 922. The Circuit Court of Appeals affirmed per curiam on the authority of *Warren Service Corp. v. Helvering,* 110 F.2d 723. 112 F.2d 167. Because of conflict with *Commissioner v. Langwell Real Estate Corp.,* 47 F.2d 841, we granted certiorari limited to the question whether, "in computing net gain or loss for income tax purposes, a taxpayer [can] offset the value of the lease canceled against the consideration received by him for the cancellation". 311 U.S. 641.

Petitioner apparently contends that the amount received for cancellation of the lease was capital rather than ordinary in-

come and that it was therefore subject to §§ 101, 111–113, and 117 (47 Stat. 169, 191, 195–202, 207) which govern capital gains and losses. Further, he argues that even if that amount must be reported as ordinary gross income he sustained a loss which § 23(e) authorizes him to deduct. We cannot agree.

The amount received by petitioner for cancellation of the lease must be included in his gross income in its entirety. Section 22(a), copied in the margin,[1] expressly defines gross income to include "gains, profits, and income derived from . . . rent, . . . or gains or profits and income from any source whatever". Plainly this definition reached the rent paid prior to cancellation just as it would have embraced subsequent payments if the lease had never been canceled. It would have included a prepayment of the discounted value of unmatured rental payments whether received at the inception of the lease or at any time thereafter. Similarly, it would have extended to the proceeds of a suit to recover damages had the Irving Trust Co. breached the lease instead of concluding a settlement. Compare *United States v. Safety Car Heating Co.,* 297 U.S. 88; *Burnet v. Sanford,* 282 U.S. 359. That the amount petitioner received resulted from negotiations ending in cancellation of the lease rather than from a suit to enforce it cannot alter the fact that basically the payment was merely a substitute for the rent reserved in the lease. So far as the application of § 22(a) is concerned, it is immaterial that petitioner chose to accept an amount less than the strict present of the unmatured rental payments rather than to engage in litigation, possibly uncertain and expensive.

The consideration received for cancellation of the lease was not a return of capital. We assume that the lease was "property" whatever that signifies abstractly. Presumably the bond in *Helvering v. Horst,* 311 U.S. 112, and the lease in *Helvering v. Bruun,* 309 U.S. 461, were also "property" but the interest coupon in *Horst* and the building in *Bruun* nevertheless were held to constitute items of gross income. Simply because the lease was "property" the amount received for its cancellation was not a return of capital, quite apart from the fact that "property" and "capital" are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments which § 22(a) expressly characterizes as gross income,

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[1] Sec. 22(a). "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as "property" or "capital".

For the same reasons, that amount was not a return of capital because petitioner acquired the lease as an incident of the realty devised to him by his father. Theoretically, it might have been possible in such a case to value realty and lease separately and to label each a capital asset. Compare *Maass v. Higgins*, No. 274, decided March 3, 1941; *Appeal of Farmer*, 1 B.T.A. 711. But that would not have converted into capital the amount petitioner received from the Trust Co. since § 22(b) (3) [2] of the 1932 Act (47 Stat. 169, 178) would have required him to include in gross income the rent derived from the property, and that section, like § 22(a), does not distinguish rental payments and a payment which is clearly a substitute for rental payments.

We conclude that petitioner must report as gross income the entire amount received for cancellation of the lease without regard to the claimed disparity between that amount and the difference between the present value of the unmatured rental payments and the fair rental value of the property for the unexpired period of the lease. The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Undoubtedly it diminished the amount of gross income petitioner expected to realize, but to that extent he was relieved of the duty to pay income tax. Nothing in § 23(e) indicates that Congress intended to allow petitioner to reduce ordinary income actually received and reported by the amount of income he failed to realize. See *Warren Service Corp. v. Commissioner, supra; Josey v. Commissioner*, 104 F.2d 453; *Tiscornia v. Commissioner*, 95 F.2d 678; *Farrelly-Walsh Inc. v. Commissioner*, 13 B.T.A. 923; *Georcke Co. v. Commissioner*, 7 B.T.A. 860; *Merckens v. Commissioner*, 7 B.T.A. 32. Compare, *United States v. Safety Car Heating Co., supra; Voliva v. Commissioner*, 36 F.2d 212; *Appeal of Denholm*, 2 B.T.A. 444. We may assume that petitioner was injured insofar as the cancellation of the lease affected the value of the realty. But that would become a deductible loss only when its extent had been fixed by a closed transaction. Regulations No. 77, Art. 171, p. 46; *United States v. White Dental Mfg. Co.*, 274 U.S. 398.

The judgment of the Circuit Court of Appeals is affirmed.

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[2] Sec. 22(b). The following items shall not be included in gross income and shall be exempt from taxation under this title: . . .

(3) The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income).

Notes

(A) See Schlosberg, "Income Tax Consequences of the Assignment or Cancellation of a Leasehold," 10 Tax L.Rev. 257 (1955).

(B) Is borrowed money taxable income? Why not? Is money paid to a corporation on the issue of its stock income to the corporation? See **sec. 118** of the 1954 Code—a new provision in that statute, although the same rule had been stated in sec. 39.22 (a)-15 of Regulations 118, and earlier regulations. See also sec. 1032 of the 1954 Code. Does the latter provision (new in the 1954 Code) open up any loop-holes, as where a corporation deals in its own stock as it would in any other item of property?

The Regulations under sec. 118 are in sec. 1.118-1 of the Income Tax Regulations.

Annuities and Life Insurance Proceeds

Annuities: **Sec. 72** of the 1954 Code

Life insurance proceeds: **Sec. 101** of the 1954 Code

Regulations have been issued under sec. 72 relating to annuities and life insurance proceeds paid while the insured is still living. These are secs. 1.72-1 through 1.72-14 of the Income Tax Regulations.

With respect to sec. 101, relating to life insurance proceeds, regulations have been issued as secs. 1.101-1 through 1.101-6 of the Income Tax Regulations.

See "Tax Benefits through Insurance Loan Plans," 45 Va.L. Rev. 703 (1959).

Annuities

When a person transfers money or other property and receives from the transferee a promise to pay certain sums at intervals, the amount so paid is likely to be an annuity. It is clearly an annuity if the period of payment is measured by a life or lives. It may be an annuity if it is for a fixed period of years.

(Under the second sentence of sec. 22(b) (2) of the 1939 Code, the Tax Court held that a payment was not an annuity when it was to be made for twenty years certain. *George H. Thornley*, 2 T.C. 220 (1943). The Treasury accepted this conclusion, and amended its regulations so as to make the annuity provisions applicable only where there are life contingencies. See sec. 39.22(b) (2)-1 and -2 of Regulations 118, following T.D. 5684, 1949-1 Cum.Bull. 50. But this is apparently changed by the 1954 Code, as sec. 72 refers to "an annuity (whether for a period certain or during one or more lives)". Query: does this make every sale of property with payments to be made in installments taxable as an annuity?)

Where there is an annuity, several methods might be used in determining the income tax consequences:

(1) There might be no tax on the receipts until the aggregate of receipts had equalled the amount paid, after which everything would be taxable. This was the method used before there was any special provision for taxing annuities. See *Burnet v. Logan,* 283 U.S. 404, 414 (1931).

(2) In 1934, this was changed by provisions added to sec. 22(b)(2) of the statute of that time, and continued into the 1939 Code. Under this, annuity receipts were taxable to the extent of 3% of the consideration paid. The excess of the receipts over 3% of the consideration was excluded as a return of capital, until the amount so excluded equalled the consideration paid—that is, until the capital expended had been returned tax free. Thereafter the entire amount received was taxable.

(3) Under the provisions enacted in 1954, a portion of each annuity payment is taxable. This is determined by taking the entire amount which will be received under the annuity in comparison to the amount paid for the annuity. A portion of each payment received is excluded from income in an amount which will just restore the capital in full when the final payment is received. This works readily enough when the annuity is for a fixed period of years. When it turns on a life expectancy, however, it cannot be told in advance how much will be received under the annuity. The statute provides that in such a case, the aggregate amount to be received is to be determined on the basis of the life expectancy of the person or persons whose lives measure the period of the annuity. It is clear of course that the actual payments may be more or less than the amount so determined, and that any particular annuitant may fail to get his capital returned, or may receive tax free much more than the amount which he expends for the annuity.

Notes

(A) An annuitant dies before he has received back the amount he paid for the annuity. Is his executor entitled to a deduction for a loss?

(B) Annuities may be commercial (purchased from an insurance company), or private, as where a father transfers property to a son, and the son agrees to pay the father so much a month as long as the father lives. In the latter case, there may be a considerable element of gift—either way. In addition, the parties take a substantial risk. Many difficult questions may arise out of such arrangements. See Rev.Rul. 239, 1953–2 Cum.Bull. 53; Davey, "Property Exchanged for a Promise to Pay an Annuity—Transferee Problems," 33 Taxes 494 (1955); Devine, "Intra-family Annuities," 26 Taxes 907 (1948).

Life Insurance Proceeds

The basic rule about life insurance proceeds is that amounts which are paid "by reason of the death of the insured" are not subject to income tax—regardless of the amount of gain that may actually be involved. Sec. 101(a) of the 1954 Code.

When a person dies, there are usually a number of options under which the proceeds of his insurance may be paid. Ordinarily, the election among these options may be made by the insured himself, before he dies, and if he does not make an election, then one may be made by the beneficiary. These elections may be summarized as follows:

(1) To take the proceeds in a lump sum. This comes squarely within sec. 101(a) of the 1954 Code, and there is no income tax.

(2) To leave the proceeds with the company under an arrangement that the company will pay interest on the proceeds, and will pay the principal either to the principal beneficiary on demand, or to secondary beneficiaries (such as children) after the death of the principal beneficiary. Under this option, the interest is taxable income. Sec. 101(c) of the 1954 Code.

(3) To pay annual installments over a fixed period of years, such as ten years, or twenty years. In such a case, the aggregate amount of the payments will exceed the face amount of the policy, since the insurance company has earnings on the proceeds during the period they are left with the company. In other words, there is an "income element" in the amounts paid to the beneficiary.

(4) To pay annual installments during the life of the beneficiary. This may be a straight annuity, ending on the death of the beneficiary, or it may be a "refund" annuity, under which the company agrees to pay at least the face amount of the policy, or it may be an annuity with an agreement that payments will be made for at least a stated number of years, such as ten years or twenty years.

The third and fourth of these plans give rise to tax problems. Under the law as it stood before the 1954 Code, it was finally settled that no part of such installment payments was subject to income tax, even though they obviously included an income element. This was true whether the election was made by the insured or by the beneficiary of the policy. See *Commissioner v. Pierce,* 146 F.2d 388 (C.C.A.2d, 1944), and sec. 39.22(b)(1)–1 of Regulations 118, following T.D. 5515, 1946–1 Cum.Bull. 26.

This result has been modified by sec. 101(d) of the 1954 Code so as to allow only a limited exclusion from income in these cases.[1] Note that under sec. 101(f) the new provision is applicable only in cases where the insured dies after the date of enactment of the 1954 Code. Where the insured died before that date, the law applicable under sec. 22(b)(2) of the 1939 Code remains applicable even to insurance proceeds payable in later years.

Note that the exemption from tax of insurance proceeds does not apply where the policy has been transferred for a valuable consideration. Sec. 101(a)(2) of the 1954 Code. See Brown, "Transfers of Life Insurance for Valuable Consideration," 28 Taxes 907 (1950); *King Plow Co. v. Commissioner*, 110 F.2d 649 (C.C.A.5th, 1940).

Note, too, that sec. 101 does not cover all payments made under life insurance policies. It relates only to payments made "by reason of the death of the insured." Where a payment is made while the insured is still living, as where he surrenders the policy, or an endowment policy matures, there is no exemption from income tax on the gain. And if the proceeds are taken in installments, the annuity provisions of sec. 72 of the 1954 Code may be applicable. See especially sec. 72(e) and (h).

Employer paid employees income tax. Ct held
that the payment of tax was income to the employ

Discharge of Indebtedness

OLD COLONY TRUST CO. v. COMMISSIONER

Supreme Court of the United States, 1929. 279 U.S. 716.

MR. CHIEF JUSTICE TAFT delivered the opinion of the court.

. . . .

The facts certified to us are substantially as follows:

William M. Wood was president of the American Woolen Company during the years 1918, 1919, and 1920. In 1918 he received as salary and commissions from the company $978,725, which he included in his federal income tax return for 1918. In 1919 he received as salary and commissions from the company $548,-132.87, which he included in his return for 1919.

August 3, 1916, the American Woolen Company had adopted the following resolution, which was in effect in 1919 and 1920:

"Voted: That this company pay any and all income taxes, State and Federal, that may thereafter become due and payable upon the salaries of all the officers of the company, including the president, William M. Wood; the comptroller, Parry C. Wiggin; the auditor, George R. Lawton; and the following members of

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1 See Post, "Taxation of Life Insurance and Annuities," 41 A.B.A.J. 129 (1955); Brunstrom, "The Life Insurance, Endowment and Annuity Features of the 1954 Code," 32 Taxes 866 (1954).

the staff, to wit: Frank H. Carpenter, Edwin L. Heath, Samuel R. Haines, and William M. Lasbury, to the end that said persons and officers shall receive their salaries or other compensation in full without deduction on account of income taxes, State or Federal, which taxes are to be paid out of the treasury of this corporation."

This resolution was amended on March 25, 1918, as follows:

"Voted: That, referring to the vote passed by this board on August 3, 1916, in reference to income taxes, State and Federal, payable upon the salaries or compensation of the officers and certain employees of this company, the method of computing said taxes shall be as follows, viz.:

" 'The difference between what the total amount of his tax would be, including his income from all sources, and the amount of his tax when computed upon his income excluding such compensation or salaries paid by this company.' "

Pursuant to these resolutions, the American Woolen Company paid to the collector of internal revenue Mr. Wood's federal income and surtaxes due to salary and commissions paid him by the company, as follows:

Taxes for 1918 paid in 1919.......	$681,169.88
Taxes for 1919 paid in 1920.......	351,179.27

The decision of the Board of Tax Appeals here sought to be reviewed was that the income taxes of $681,169.88 and $351,179.27 paid by the American Woolen Company for Mr. Wood were additional income to him for the years 1919 and 1920.

The question certified by the Circuit Court of Appeals for answer by this Court is:

"Did the payment by the employer of the income taxes assessable against the employee constitute additional taxable income to such employee?" [1]

Coming now to the merits of this case, we think the question presented is whether a taxpayer, having induced a third person to pay his income tax or having acquiesced in such payment as made in discharge of an obligation to him, may avoid the making of a return thereof and the payment of a corresponding tax. We think he may not do so. The payment of the tax by the employers was in consideration of the services rendered by the employee, and was again derived by the employee from his labor. The form of the payment is expressly declared to make no difference. Section 213, Revenue Act of 1918, c. 18, 40 Stat.

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[1] The first portion of the opinion, in which the jurisdiction of the federal courts to review decisions of the Board of Tax Appeals was sustained, is omitted.

1065. It is therefore immaterial that the taxes were directly paid over to the government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed. The certificate shows that the taxes were imposed upon the employee, that the taxes were actually paid by the employer, and that the employee entered upon his duties in the years in question under the express agreement that his income taxes would be paid by his employer. This is evidenced by the terms of the resolution passed August 3, 1916, more than one year prior to the year in which the taxes were imposed. The taxes were paid upon a valuable consideration, namely, the services rendered by the employee and as part of the compensation therefor. We think, therefore, that the payment constituted income to the employee. . . .

Nor can it be argued that the payment of the tax in No. 130 was a gift. The payment for services, even though entirely voluntary, was nevertheless compensation within the statute. This is shown by the case of *Noel v. Parrott* (C.C.A.) 15 F.2d 669. There it was resolved that a gratuitous appropriation equal in amount to $3 per share on the outstanding stock of the company to be set aside out of the assets for distribution to certain officers and employees of the company, and that the executive committee be authorized to make such distribution as they deemed wise and proper. The executive committee gave $35,000 to be paid to the plaintiff taxpayer. The court said [page 672 of 15 F.2d]:

"In no view of the evidence, therefore, can the $35,000 be regarded as a gift. It was either compensation for services rendered or a gain or profit derived from the sale of the stock of the corporation, or both; and, in any view, it was taxable as income."

It is next argued against the payment of this tax that, if these payments by the employer constitute income to the employee, the employer will be called upon to pay the tax imposed upon this additional income, and that the payment of the additional tax will create further income which will in turn be subject to tax, with the result that there would be a tax upon a tax. This, it is urged, is the result of the government's theory, when carried to its logical conclusion, and results in an absurdity which Congress could not have contemplated.

In the first place, no attempt has been made by the Treasury to collect further taxes, upon the theory that the payment of the additional taxes creates further income, and the question of a tax upon a tax was not before the Circuit Court of Appeals, and has not been certified to this Court. We can settle questions of that sort when an attempt to impose a tax upon a tax is under-

taken, but not now. *United States v. Sullivan,* 274 U.S. 259, 264; *Yazoo & Mississippi Valley R. Co. v. Jackson Vinegar Co.,* 226 U.S. 217, 219. It is not, therefore, necessary to answer the argument based upon an algebraic formula to reach the amount of taxes due. The question in this case is, "Did the payment by the employer of the income taxes assessable against the employee constitute additional taxable income to such employee?" The answer must be "Yes."

Notes and Problem

(A) The same result was reached in *United States v. Boston and Maine Railroad,* 279 U.S. 732 (1929), with respect to taxes paid by a lessee railroad on its lessor's income, pursuant to the provisions of the lease. In this case, the district court had said (*Boston and Maine Railroad v. United States,* 23 F.2d 343, 344 (D.Mass., 1927)): "If the government's contention is sound, the Treasury Department has discovered a manner of creating wealth —the age-long search for the philosopher's stone, which would turn into gold whatever it touched, has at last successfully ended. By merely laying the primary tax, the Department thereby creates income, which is subject to a secondary tax; this in turn is further income, which is subject to a tertiary tax; and this in its turn gives rise to a quaternary tax; and so on ad infinitum." Is this sound? Is it possible to compute the exact amount of the total tax? How? Was the Government's concession in the *Old Colony Trust* case necessary? Was it desirable? Would the Government make the same concession today? [1]

Note Sec. 110 of the 1954 Code, which stops pyramiding of the tax on old leases. See *Connecticut Railway and Lighting Co. v. United States,* 135 Ct.Cls. 650, 142 F.Supp. 907 (1956), which holds that there should be no pyramiding of the tax prior to 1954 because of the Government's concession in the *Old Colony Railroad* case and its long-continued practice to that effect.

(B) With respect to the problem of the *Old Colony Trust Company* case, see the provision of sec. 1.61–12(a) of the Income Tax Regulations.

(C) In *United States v. Joliet and Chicago R. Co.,* 315 U.S. 44 (1942), the lease was in perpetuity. The taxpayer contended that it had lost all right and interest in the property, and that it had no right to or control over the dividends paid directly by the lessee to the lessor's stockholders. The Court held that the dividend payments were taxable as income to the lessor.

(D) A railroad lease provided that the lessee should pay the lessor's taxes. Supposedly in accordance with this contract, the lessee paid the federal income taxes assessed against the lessor. Some years later, it was decided that the lease did not in fact require the lessee to pay income taxes. See *Brainard v. New York Central R. Co.,* 242 N.Y. 125, 151 N.E. 152 (1926). Were the payments actually made taxable as income to the lessor? *United States v. Mahoning Coal R. R. Co.,* 51 F.2d 208 (C.C.A.6th, 1931), cert. den. 285 U.S. 559 (1931).

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[1] For an interesting argument, see Kades, "Phantom Income: Net Leases and The Clark Case," 5 Syracuse L.Rev. 18 (1953).

(E) As far as paying the lessor's taxes are concerned, the question is a relatively easy one. The parties may dispute as to the extent of the lessee's obligation. However, the Treasury will accept "the construction given by the parties to the contract under which such taxes are paid." Mim. 6779, 1952–1 Cum.Bull. 8. Whatever amount is paid by the lessee is income to the lessor.

(F) In *Ethel S. Amey*, 22 T.C. 656 (1954), a lease provided that the lessee, in addition to paying rent direct to the lessor, should make payments on a mortgage on the property. It was held that these payments to the mortgagee were income to the lessor even though the lessor was not personally liable on the mortgage.

Co purchased its own bonds at a discount. Ct held it to be taxable.

UNITED STATES v. KIRBY LUMBER CO.

Supreme Court of the United States, 1931. 284 U.S. 1.

MR. JUSTICE HOLMES delivered the opinion of the court.

In July, 1923, the plaintiff, the Kirby Lumber Company, issued its own bonds for $12,126,800 for which it received their par value. Later in the same year it purchased in the open market some of the same bonds at less than par, the difference of price being $137,521.30. The question is whether this difference is a taxable gain or income of the plaintiff for the year 1923. By the Revenue Act of (November 23) 1921, c. 136, sec. 213(a), 42 Stat. 238, gross income includes "gains or profits and income derived from any source whatever," and by the Treasury Regulations authorized by sec. 1303, that have been in force through repeated re-enactments, "If the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year." Article 545(1) (c) of Regulations 62, under Revenue Act of 1921. See Article 544(1) (c) of Regulations 45, under Revenue Act of 1918; Article 545(1) (c) of Regulations 65, under Revenue Act of 1924; Article 545(1) (c) of Regulations 69, under Revenue Act of 1926; Article 68(1) (c) of Regulations 74, under Revenue Act of 1928. We see no reason why the Regulations should not be accepted as a correct statement of the law.

In *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, the defendant in error owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment the marks had fallen in value, which so far as it went was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the contention was denied. Here there was no shrinkage of assets, and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset

by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here. *Burnet v. Sanford & Brooks Co.,* 282 U.S. 359, 364.

Judgment reversed.

Notes and Problems

(A) For the present provision of the Regulations, see sec. 1.61–12(c) of the Income Tax Regulations.

(B) In *Helvering v. American Chicle Co.,* 291 U.S. 426 (1934), the bonds were assumed by the taxpayer in connection with the purchase of property. When the bonds were thereafter bought at a discount, it was argued that this was a reduction of the purchase price of the property. This argument was rejected and the discount was held to be taxable income. See also *Commissioner v. Coastwise Transportation Corp.,* 71 F.2d 104 (C.C.A.1st, 1934), noted in 44 Yale L.J. 144 (1934).

Where the creditor deals directly with the original debtor, however, as where property is purchased, with a mortgage given for part of the purchase price, and the mortgage is subsequently discharged for less than its face amount, there has been some tendency to hold that the reduction is not income, particularly when the amount actually paid on the mortgage is equal to or more than the then value of the property. See *Hirsch v. Commissioner,* 115 F.2d 656 (C.C.A.7th, 1940), noted in 54 Harv.L. Rev. 1071 (1941). The same result has been reached where the taxpayer bought property subject to an obligation for which he was not personally liable, and subsequently discharged the obligation for less than its face amount. *Hotel Astoria, Inc.,* 42 B.T.A. 759 (1940).

(C) Suppose the statute of limitations runs against the enforcement of a debt, the debtor being solvent. Does the debtor have income from the discharge of the debt? See *Securities Co. v. United States,* 85 F.Supp. 532 (S.D.N.Y.1948), where it was held that there was income.

(D) A corporation issued bonds as a dividend to its shareholders. Later it bought some in at less than par. Did this produce income? *Commissioner v. Rail Joint Co.,* 61 F.2d 751 (C.C.A.2d, 1932); *Fashion Park, Inc.,* 21 T.C. 600 (1954). See also *Transylvania R. Co. v. Commissioner,* 99 F.2d 69 (C.C.A.4th, 1938), involving bonds issued by a lessor railroad company on which the interest had been guaranteed by the lessee. The lessor bought some of the bonds at a discount and kept them in its treasury in order that it might collect the interest payments from the lessee.

In *Commissioner v. Pittsburgh & W. V. Ry. Co.,* 172 F.2d 1010 (C.A.3d, 1949), cert. den. 337 U.S. 939 (1949), the taxpayer purchased its bonds on the market at a discount. Pursuant to prior contract, it immediately pledged them as additional security for a junior bond issue. It was held that income was derived at the time of the purchase.

See Molloy, "Federal Income Tax Aspects of New Trends in Railroad Corporate Finance," 12 Tax L.Rev. 113 (1957).

(E) A corporation is indebted to a sole shareholder. The shareholder forgives the indebtedness. Is this income to the corporation, or a gift, or simply a further investment by a shareholder, a contribution to the capital of the corporation? See *United States v. Oregon-Washington R. R. & Nav. Co.*, 251 F. 211 (C.C.A.2d, 1918); *Commissioner v. Auto Strop Safety Razor Co.*, 74 F.2d 226 (C.C.A.2d, 1934).

(F) If a person is insolvent, and settles with his creditors at a discount, is the discount income? Does a discharge in bankruptcy make the bankrupt subject to an income tax? See *Dallas Transfer and Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (C.C.A.5th, 1934). What does the provision of sec. 1.61–12 (b) of the Income Tax Regulations on this mean?

Consider the special provisions on this subject in sections 268–270 of the Chandler Act, Act of June 22, 1938, c. 575, 52 Stat. 883, under which the basis of the taxpayer's property must be reduced by the amount of indebtedness discharged in a Chandler Act proceeding.[1] These have been rather troublesome,[2] and Congress has made them expressly inapplicable to certain corporate reorganizations. See secs. 372 and 373 of the 1954 Code. In *Claridge Apartments Co. v. Commissioner*, 323 U.S. 141 (1944), it was held that the provision for reduction of basis in sec. 270 was not applicable in a case where the final decree of the bankruptcy court had been entered prior to the enactment of the Chandler Act in 1938.

(G) Suppose that a corporation having bonds outstanding goes through a reorganization, under the Chandler Act or otherwise, as a result of which the bonds are cancelled, and stock is issued to the bondholders in their place. In *Commissioner v. Motor Mart Trust*, 156 F.2d 122 (C.C.A.1st, 1946), it was held that there was no cancellation of indebtedness, but merely a use of the bonds to pay for the stock. This result has now been accepted by the Commissioner. See G.C.M. 25277, 1947–1 Cum.Bull. 44.

(H) In 1939, Congress enacted the forerunner of the present secs. 108 and 1017 of the 1954 Code, under which income derived by a corporation from the discharge of its securities is not taxed, but a corresponding reduction in the basis of the taxpayer's property is required. This has now been extended, by the 1954 Code, to individuals, and the limitation to "securities" has been removed.

(I) These problems have not been very live ones in recent years, but they would quickly recur in a declining economy.

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1 Sec. 270 and related provisions of the Chandler Act were amended by the Act of June 22, 1940. The reduction of basis provided by the original statute is limited by the amendment so that the basis will not be reduced below the actual market value of the property.

2 Discussions of the problems may be found in "Income Tax Provisions of the Chandler Act," 6 U. of Chi.L.Rev. 447 (1939); "Reorganization Income Tax Provisions of the Chandler Act," 35 Ill.L.Rev. 192 (1940); Paul, "Debt and Basis Reduction under the Chandler Act," 15 Tulane L.Rev. 1 (1940); Banks, "Section 270 of the Federal Bankruptcy Act," 76 J. of Accountancy 331 (1943).

General discussions may be found in Darrell, "Discharge of Indebtedness and the Federal Income Tax," 53 Harv.L.Rev. 977 (1940); Surrey, "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness," 49 Yale L.J. 1153 (1940); Warren and Sugarman, "Cancellation of Indebtedness and Its Tax Consequences," 40 Col.L.Rev. 1326 (1940), 41 Col. L.Rev. 61 (1941). See also Eustice, "Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion," 14 Tax L.Rev. 225 (1959). interest & rent were gratuitous gifts / taxable. The S/Ct reversed the Tax Cts determin. whether for bus. or not

HELVERING v. AMERICAN DENTAL CO.

Supreme Court of the United States, 1943. 318 U.S. 322

MR. JUSTICE REED delivered the opinion of the Court.

This writ of certiorari brings here for review the question of the taxability, as income, of rent and interest on accounts owed by the taxpayer which were cancelled by its creditors.

The taxpayer, a corporation, respondent here, owed certain past due bills for merchandise. This indebtedness was represented by interest bearing notes. Interest upon these notes had been accrued for the years prior to 1937 and deducted in the taxpayer's income tax returns, to the amount of $11,435.22. In November, 1936, the creditors agreed to cancel all interest accruing after January 1, 1932. The first entry on the taxpayer's books which records the cancellation appears in December, 1937, the tax year here involved, when over $16,000 was credited.

The taxpayer in December, 1933, also owed back rent amounting to $15,298.99. This back rent had been accrued as an expense. A new lease was negotiated at that time and the lessor promised to make an adjustment of the accumulated obligation. The following April the lessor advised the taxpayer that he would accept $7500 in payment of the back rent and would cancel the rest. The reduced sum was paid in February, 1937, by cash and notes which were met the same year. In 1937 the first entries were made on both the lessor's and the taxpayer's books, showing the partial forgiveness of the back rent.

The date of the book entries of the cancellations and the deduction of the interest for the whole of 1936 by the taxpayer led the Board of Tax Appeals to uphold the Commissioner's determination that the cancellation of all items of indebtedness involved here took place in 1937. This determination is accepted by us. *Wilmington Trust Co. v. Commissioner,* 316 U.S. 164, 168.

The taxpayer credited the total amount of the cancelled debts, $25,219.65 to earned surplus.[1] It did not return any of the sum as taxable income. No proof appears of the insolvency of the tax-

[1] There is an unexplained and immaterial variance between the sum of the items cancelled and the total credited to surplus.

payer before or after the cancellation. Its balance sheets show assets exceeding liabilities at the opening and close of 1937 with net assets greater than the asserted adjustment of income. Under these circumstances the Commissioner increased the taxpayer's reported income by $19,234.21, the sum of the items of the cancelled indebtedness which the Board of Tax Appeals found had served to offset income in like amounts in prior years. The taxpayer had accrued the rent and interest in former years. No claim for additional taxes is made by the Commissioner.

The taxpayer sought a redetermination on the ground that the cancellations were exempt gifts and that it was not enriched beyond the tax advantages gained by the deductions in former tax returns. The Board of Tax Appeals found that the cancellations were not gifts, concluded that the tax benefits in dollars obtained by the deductions of former years did not limit the 1937 tax springing from the cancellation and affirmed the commissioner's determination of a deficiency. The Court of Appeals reversed on the ground that the cancellations constituted exempt gifts. On account of a variety of views in the circuits as to the taxability of similar adjustments of indebtedness, we granted certiorari.

The applicable statutory provisions are Section 22(a) and (b)(3) of the Revenue Act of 1936. The general definition of gross income has varied little in the successive revenue acts, and, from the earliest, gifts have been excluded by substantially identical statutory language. Act of October 3, 1913, 38 Stat. 166. The Treasury Department Regulations 94, relating to the Revenue Act of 1936, Art. 22(a)–14, covered cancellation of indebtedness.[2] This regulation first appeared in Regulations 86 under the 1934 Act. It marked a change in the Treasury's concept of the tax effect of debt forgiveness. The old article as it appeared in Regulations 77, relating to the 1932 act, read in part:

"If however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income."

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[2] "Art. 22(a)–14. Cancellation of indebtedness.—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22(a)–18.) If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. Income is not realized by a taxpayer by virtue of the discharge of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of a composition agreement among his creditors, if immediately thereafter the taxpayer's liabilities exceed the value of his assets."

The article relating to the exclusion of gifts from gross income is not helpful. It merely says gifts are exempt from the income tax. Art. 22(b)(3)–1.

The same language appeared in the former Regulations.[3]

In fields closely related to the cancellation of indebtedness which we are considering here, this Court has treated gains in net assets as income. In *United States v. Kirby Lumber Co.*, 284 U. S. 1, the taxpayer purchased its own bonds at a discount. It was held taxable on the increase in net assets which resulted. This holding was confirmed by *Helvering v. American Chicle Co.*, 291 U.S. 426. See also *Commissioner v. Coastwise Transp. Corp.*, 71 F.2d 104. Forfeiture or surrender of a lease by which the lessor gains property or money makes such gain taxable. *Helvering v. Bruun*, 309 U.S. 461; *Hort v. Commissioner*, 313 U.S. 28. The narrow line between taxable bonuses and tax free gifts is illuminated by *Bogardus v. Commissioner*, 302 U.S. 34, on the one side and upon the other by *Noel v. Parrott*, 15 F.2d 669, as approved in *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 730.

Normally cancellations of indebtedness occur only when the beneficiary is insolvent or at least in financial straits. Possibly because it seems beyond the legislative purpose to exact income taxes for savings on debts, the courts have been astute to avoid taxing every balance sheet improvement brought about through a debt reduction. Where the indebtedness has represented the purchase price of property, a partial forgiveness has been treated as a readjustment of the contract rather than a gain. *Hirsch v. Commissioner*, 115 F.2d 656; *Helvering v. A. L. Killian Co.*, 128 F.2d 433; *Gehring Publishing Co., Inc. v. Commissioner*, 1 T.C. 345. Where a stockholder gratuitously forgives the corporation's debt to himself, the transaction has long been recognized by the Treasury as a contribution to the capital of the corporation. Regulations 45, Art. 51, through to Regulations 94, Art. 22(a)–14. *Commissioner v. Auto Strop Safety Razor Co., Inc.*, 74 F.2d 226.

In the light of these views upon gain, profit and income, we must construe the meaning of the statutory exemption of gifts from gross income by Section 22(b)(3). The broad import of gross income in Section 22(a) [4] admonishes us to be chary of extending any words of exemption beyond their plain meaning. Cf. *Heiner v. Colonial Trust Co.*, 275 U.S. 232, 235; *United States v. Stewart*, 311 U.S. 60, 63. Gifts, however, is a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear. Its plain meaning in its present setting denotes, it seems to us, the receipt of financial advantages gratuitously.

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[3] Regulations 74, Art. 64 (1931); Regulations 69, Art. 49 (1926); Regulations 65, Art. 49 (1924), for individuals; Regulations 62, Art. 50 (1922), for individuals; Regulations 45 (1920 ed.), Art. 51, for individuals.

When the gift tax was revived in 1932, the House Report gave as an example of a gift "the forgiveness or payment by A of B's indebtedness." H.Rep. No. 708, 72nd Cong., 1st Sess., p. 28(5).

[4] Helvering v. Clifford, 309 U.S. 331, 334.

The release of interest or the complete satisfaction of an indebtedness by partial payment by the voluntary act of the creditor is more akin to a reduction of sale price than to financial betterment through the purchase by a debtor of its bonds in an arms-length transaction. In this view, there is no substance in the Commissioner's differentiation between a solvent or insolvent corporation or the taxation of income to the extent of assets freed from the claims of creditors by a gratuitous cancellation of indebtedness. *Lakeland Grocery Co. v. Commissioner,* 36 B.T.A. 289. Cf. *Madison Railways Co. v. Commissioner,* 36 B.T.A. 1106; *Spokane Office Supply Co. v. Commissioner,* Docket No. 86762, memo. op. of April 29, 1939; *Model Laundry, Inc. v. Commissioner,* Docket No. 93493; memo. op. of January 15, 1940. See also *Haden Co. v. Commissioner,* 118 F.2d 285, which supports the Commissioner.

The Board of Tax Appeals decided that these cancellations were not gifts under Section 22(b) (3). It was said:

"No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity." 44 B.T.A. 425, 428.

With this conclusion we cannot agree. We do not feel bound by the finding of the Board because it reached its conclusions, in our opinion, upon an application of erroneous legal standards. Section 22(b) (3) exempts gifts. This does not leave the Tax Court of the United States free to determine at will or upon evidence and without judicial review the tests to be applied to facts to determine whether the result is or is not a gift. The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute.

Affirmed.

MR. JUSTICE FRANKFURTER, dissenting.

When Congress wished to exempt income "attributable to the discharge . . . of any indebtedness" it did so explicitly. It defined such exemption with particularity and only to a limited extent, as illustrated by the various enactments, including § 114 of the Revenue Act of 1942, all of which appear to throw light leading away from and not towards the conclusion drawn from them by the Court. In the absence of such specific exemption of what as a practical matter may be income, determination of whether it is or is not income should be left to the tribunal whose special business it is to ascertain the controverted facts and the reasonable inferences from them. In deciding that, in the cir-

cumstances of the present case, the debt cancellations were not gifts and therefore taxable, the Board of Tax Appeals (now the Tax Court of the United States) did not invoke wrong legal standards. It knew well enough the difference between taxable income and gifts. It applied these legal concepts to its interpretation of the facts. That its judgment should not be upset is counselled by wise fiscal as well as judicial administration.

MR. JUSTICE JACKSON joins in this dissent.[5]

Note

George A. Adams, Memo. T.C. June 28, 1944, and *Cocheco Woolen Mfg. Co.,* Memo. T.C., June 28, 1945, are an interesting pair of cases. Both arose out of the same transaction by which Cocheco settled its debt to Adams by a payment of less than the face amount. Adams' contention that he could deduct the difference as a bad debt was sustained. The Commissioner's contention that Adams had made a gift was rejected. When Cocheco's case came up, the Adams record was stipulated as a part of the Cocheco record. The Tax Court held that Cocheco did not have income, since it dealt directly with its creditor. It was held that this result was required by the *American Dental* case.

[illegible] T/P bought bonds back at discount [illegible] because it took the aspect of a sale & was not a [illegible] of the debt

COMMISSIONER v. JACOBSON

Supreme Court of the United States, 1949. 336 U.S. 28.

[The taxpayer, an individual, had issued bonds for the purpose of raising money to finance various transactions in which he was engaged. In 1938, 1939, and 1940 he bought in a considerable number of these bonds at a discount. Some of the purchases were made direct from the owners, some were bought through brokers, and some were bought through a bondholders' committee. The taxpayer was solvent in these years, though in straitened financial circumstances. The Tax Court held that he was not taxable with respect to the bonds bought direct from the holders, but was taxable on the gain derived from those bought through brokers or the bondholders' committee.

The Supreme Court held him taxable on the gain resulting from all of the purchases. The closing portion of a long opinion by MR. JUSTICE BURTON follows:]

The only provision for the exclusion of thse types of gains from the respondent's gross income that is presented for our consideration is the general exemption of gifts from taxation prescribed by § 22(b)(3). This was applied by this Court in favor of a taxpayer in *Helvering v. American Dental Co.,* 318 U.S. 322,

[5] For a discussion in the light of the American Dental case, see Lynch, "Some Tax Effects of Cancellation of Indebtedness," 13 Fordham L.Rev. 145 (1944).

as well as by the court below in the instant case. Both the general provision for taxation of income and this provision for the exclusion of gifts from gross income, for income tax purposes, have been in the Federal Income Tax Acts in substantially their present form since the Revenue Act of 1916. The contrast between the provisions is striking. The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed with restraint in the light of the same policy. Congress could have excluded from the gross income of all taxpayers the gains derived by debtors either from their acquisitions of their own obligations at a discount and their consequent control over them, or from their respective releases from all or part of such obligations by their respective creditors upon the debtor's payment to the creditor of something less than the full amount of the debt. Congress, especially since the Revenue Act of 1938, has been cognizant of this issue and of its power to meet it as stated, but it has chosen to extend such relief only on the above described restricted and temporary basis and only in the case of corporations. In its treatment of the issue Congress also has required the corporate taxpayer's consent to an alternative plan for a reduction of the corporation's basis of property values to be used in later determinations of its gains or losses. This special treatment is far different from the total exclusion of a gain resulting from an exempt gift. If such gains were already exempted as gifts under § 22(b)(3), as representing something transferred to the debtor for nothing, there would have been no need for § 22(b)(9). The conclusion to be drawn is that such transfers as are described in § 22(b)(9) could not, without more, qualify as exempt gifts under § 22(b)(3). The same may be said of the acquisition, by a natural person, of his own obligations as debtor. The facts in the instant case present a situation quite similar to one contemplated by § 22(b)(9) except that the taxpayer here is a natural person. This emphasizes the taxability of the gains before us.

In the instant case the relation between the bondholder and the respondent may be assumed in each transaction to have been one in which the ultimate parties were known to each other to be such. There was no suggestion in the evidence or the findings that any bondholder was acting from any interest other than his own. Each transaction was a sale. The seller sought to get as high a price as he could for the bond and the buyer sought to pay as low a price as he could for the same bond. If the transaction had been completely on the open market through a stock exchange, the conduct and intent of each party could have been the same and there would have been little, if any, basis for any claim

that the respondent's gain was not taxable income. The mere fact that the seller knew that he was selling to the maker of the bond as his only available market did not change the sale into a gift. In the absence of proof to the contrary, the intent of the seller may be assumed to have been to get all he could for his entire claim. Although the sales price was less than the face of the bond and less than the original issuing price of the bond, there was nothing to indicate that the seller was not getting all that he could for all that he had. There is nothing in the evidence or findings to indicate that he intended to transfer or did transfer something for nothing. The form of the transaction emphasized this relationship. The seller assigned the entire bond to his purchaser. The seller did not first release the maker from a part of the maker's obligation and, having made the maker a gift of that release, then sell him the balance of the bond or vice versa. If the seller actually had intended to give the maker some gift the natural reflection of that gift would have been a credit on the face of the bond or at least some record or testimony evidencing the release. This is not saying that the form of the transaction is conclusive. Assuming that the extension of the maturity of the bonds in the instant case was binding on the creditor, we do not rest this case upon the fact that the sale was made before maturity or that the seller may have received valid consideration for a total release of his claim because the debtor's payment was made before maturity. It is quite possible that a bondholder might make a gift of an entire bond to any one, including the maker of it. The facts and findings in this case do not establish any such intent of the seller to make a gift in contradiction of the natural implications arising from the sales and assignments which he made. It is conceivable, although hardly likely, that a bondholder, in the ordinary course of business and without any express release of his debtor, might have sold part of his claims on the bonds he held at the full face value of those parts and then have made a gift of the rest of his claims on those bonds to the same debtor "for nothing." It is that kind of extraordinary transaction that the respondent asks us, as a matter of law, to read into the simple sales which actually took place and from which he derived financial gains. We are unable to do so on the findings before us. Cf. *Bogardus v. Commissioner,* 302 U.S. 34.

The situation in each transaction is a factual one. It turns upon whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and of the balance "for nothing." The latter situation is more likely to arise in connection with a release of an open account for rent or for interest, as was found to have occurred in *Helvering v. American Dental Co.,* [318 U.S. 322], than in the sale of outstanding securities, either of a corporation

as described in § 22(b)(9), or of a natural person as presented in this case. For these reasons we hold that the Commissioner was justified in finding a taxable gain, rather than an exempt gift, in each of the transactions before us. The judgment of the Court of Appeals accordingly is reversed and the cause is remanded for further action in accordance with this opinion.

It is so ordered.

MR. JUSTICE RUTLEDGE, although joining in the Court's judgment and opinion, is of the view that the result is essentially in conflict with that reached in *Helvering v. American Dental Co.,* 318 U.S. 322.

MR. JUSTICE REED, with whom MR. JUSTICE DOUGLAS joins, dissenting.

As detailed in *Helvering v. American Dental Company,* 318 U.S. 322, the problems of the tax results to the debtor of the release of indebtedness have been difficult. That opinion shows that both Congress and Internal Revenue Regulations have taken varying views as to whether a taxpayer should pay an income tax on such balance sheet improvements.[1]

We held in the *American Dental* case in 1943 that the "receipt of financial advantages gratuitously" was a gift under Int.Rev. Code § 22. Congress has made no change in the law since that time, nor has it been requested to do so. For the reasons discussed at length in that case, we are of the opinion that the judgment of the Court of Appeals should be affirmed.

Notes

(A) See Chommie, "The Debt Release: Gift or Increase in Net Worth," 4 Utah L.Rev. 36 (1954).

(B) In *Helvering v. Midland Mutual Life Ins. Co.,* 300 U.S. 216 (1937), the insurance company held a mortgage on land. It foreclosed the mortgage, and bid it in on the foreclosure sale for the amount of the principal of the debt plus interest and costs. There were no other bidders at the sale, but the insurance company bid this amount both because it had a policy not to take deficiency judgments, and because it wanted to prevent redemption of the property for any smaller amount. The Court held that the amount allocable to interest was taxable income. See Dohr, "Income Divorced from Reality," 66 J. of Accountancy 361 (1938). *Cf. Nichols v. Commissioner,* 141 F.2d 870 (C.C.A.6th, 1944), which is very nearly *contra.*

Would the mortgagor in such a case be entitled to a deduction for interest paid? See *Blossom v. Commissioner,* 38 B.T.A. 1136 (1938).

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[1] Helvering v. American Dental Co., supra, p. 326, note 5; p. 328, note 9, particularly tax free railroad adjustments under c. XV, § 735, 53 Stat. 1140.

WILLARD HELBURN, INC. v. COMMISSIONER

Court of Appeals, First Circuit, 1954. 214 F.2d 815.

MAGRUDER, CHIEF JUDGE. We have for review a decision of the Tax Court of the United States determining a deficiency of $35,-325.95 in income taxes of Willard Helburn, Inc., for the fiscal year ending November 30, 1949. The only issue to be considered is whether the Tax Court correctly ruled that petitioner, due to the devaluation of the pound sterling from $4.04 to $2.81 on September 18, 1949, realized additional taxable income in the sum of $84,047.36 in a transaction incident to the purchase by petitioner of certain lots of lambskins in New Zealand in April and May of the fiscal year in question.

The facts are covered by a stipulation of the parties, and are not in dispute:

Petitioner is a Massachusetts corporation engaged in the manufacture and sale of leather and leather products, with its principal place of business in Peabody, Massachusetts. It filed its corporate income tax return for its fiscal year ending November 30, 1949, with the Collector of Internal Revenue for the District of Massachusetts, reporting in this return a taxable net income of $27,413.68. It maintained its books and records and reported its income on an accrual method of accounting.

On April 13, 1949, and on May 25, 1949, petitioner successfully bid on various lots of lambskins up for sale at auctions in Wellington, New Zealand. Mair & Company, Ltd., a New Zealand firm, acted as agent of petitioner, on a commission basis, to effect all arrangements for the acquisition of the skins and their shipment to petitioner, including payment for the skins, booking of shipping space, and clearance of all necessary commercial and government shipping documents in New Zealand.

Having previously established credit with Brown Brothers Harriman & Co., a commercial banking firm in Boston, Mass., petitioner procured from that firm on April 21, 1949, and on May 31, 1949, two letters of credit issued to Mair & Company Ltd., authorizing it to draw on Brown, Shipley & Co., Limited, for pounds sterling provided that it accompany the drafts by bills of lading for skins shipped to the petitioner. Brown, Shipley & Co., Limited, a commercial bank in London, England, acted as London correspondent of Brown Brothers Harriman & Co. Duplicate originals of these letters of credit were transmitted to Brown Shipley, and advices with respect thereto were sent by cable to the Bank of New South Wales, Christchurch, N. Z. On April 25, 1949, and June 1, 1949, petitioner entered into customers' agreements with Brown Brothers Harriman (the form of

which agreements was set forth on the reverse side of the letters of credit above mentioned).

Acting upon instructions from petitioner, the vendors of these skins invoiced each lot which had been bid in by petitioner to Mair & Company in New Zealand currency. Upon receipt of each respective invoice, Mair & Company booked shipping space for the particular lot of skins and prepared the necessary export papers. With its own funds it then paid the vendors in New Zealand currency, took possession of the skins, and, duly placing each lot aboard ship, received bills of lading. Thereafter Mair & Company prepared its invoices to petitioner. It then presented at the Bank of New South Wales all the documents and sight drafts in pounds sterling on Brown Shipley for the respective amounts of the invoices.

The Bank of New South Wales negotiated the sight drafts, thereby paying Mair & Company in New Zealand currency; and forthwith forwarded the sight drafts, accompanied by commercial invoices and bills of lading to Brown Shipley, which paid the drafts in pounds sterling. At the same time as it forwarded the sight drafts, to Brown Shipley, the Bank of New South Wales sent the original bills of lading and other documents to Brown Brothers Harriman in Boston.

When Brown Shipley in London paid these sight drafts, it notified Brown Brothers Harriman of such fact by cable, and upon notification by Brown Brothers Harriman of its obligations to Brown Shipley by reason of such payments, petitioner then requested Brown Brothers Harriman to procure from Brown Shipley the acceptance of time drafts in payment of such obligations.

Pursuant thereto, Brown Shipley at the request of Brown Brothers Harriman agreed to accept and thereafter did accept drafts at 120 days sight, drawn and endorsed in blank by petitioner, and payable in London in pounds sterling. Upon such acceptance, Brown Shipley negotiated these drafts in the London market to effect its repayment in pounds sterling of the sight draft which had been drawn on it by Mair & Company.

Brown Brothers Harriman, upon receipt of the documents from the Bank of New South Wales, endorsed the bills of lading and forwarded the same to petitioner with the applicable invoices and other shipping documents for the respective lot or lots of skins, together with trust receipts pursuant to the customers' agreements between Brown Brothers Harriman and petitioner. As each set of the invoices and shipping documents was received by petitioner, it signed such a trust receipt.

Also, upon receipt of the Mair & Company commercial invoices, petitioner recorded on its books each purchase in pounds

sterling and in dollars at the rate of exchange prevailing as of the date of the respective invoices, and made a corresponding entry to "Drafts Payable". (Since all of said invoices were dated prior to September 18, 1949, the applicable rate of exchange was $4.04 per pound sterling.)

As each lot of skins was received by petitioner, it was mingled with petitioner's stock in trade for use in the usual course of petitioner's business.

The pound sterling was devalued on September 18, 1949, from $4.04 to $2.81.

Brown Brothers Harriman notified petitioner of each date when payment of the 120-day sight drafts would be payable in pounds sterling in London, and petitioner thereupon effectuated payment of said drafts by purchasing pounds sterling through Brown Brothers Harriman with dollars at the current rate of exchange ($2.81), which by ordinary commercial processes were received by Brown Shipley in London. Brown Shipley then discharged its obligation as acceptor of each draft by payment in pounds sterling to the holder thereof.

Petitioner as of the end of the taxable year (November 30, 1949) had made entries in its books aggregating the following amounts:

Dr. Drafts Payable	$276,108.20	
Cr. Cash		$192,060.84
Cr. Other Income		$ 84,047.36

The figure "Drafts Payable" represented the amount of the drafts for pounds sterling stated in dollars at the exchange rate of $4.04 applicable at the time the pounds sterling were in effect borrowed from Brown Shipley. The cash item represented the dollars later required to purchase sufficient pounds sterling at the lower exchange rate of $2.81 in order to pay the 120-day sight drafts. The item of $84,047.36, denominated in petitioner's books "Other Income", is the difference between the foregoing two items, which the Commissioner contends should be included in the taxable income of petitioner for the fiscal year in question.

It seems to us that taxwise there are two possible ways in which the foregoing events might be viewed:

(1) The purchases of the skins in New Zealand and the various financial arrangements whereby petitioner ultimately discharged in dollars its obligations arising out of such purchases might be regarded as a single integrated transaction. So regarded, the cost of the skins, as raw materials added to petitioner's inventory during the taxable year, was actually a great deal

less, in terms of dollars ~~paid out by petitioner~~ for the goods, than would have been the case had the relationship between the dollar and the pound sterling remained as it was when the skins were purchased in New Zealand ~~in April and~~ May of 1949. Under this tax treatment, the pecuniary advantage which petitioner gained from the devaluation of the pound on September 18, 1949, would in the ordinary case, at least, have been duly reflected in increased net profits taxable to petitioner for the fiscal year in question.

(2) The purchases of the skins of New Zealand might be viewed separately and distinct from the subsequent financial arrangements between petitioner, Brown Brothers Harriman, and Brown Shipley. Thus, when Mair & Company, as agent for petitioner, paid the New Zealand vendors for the skins, petitioner would take as its costs for the goods added to its inventory in the taxable year the amounts paid therefor by the New Zealand agent (plus commissions, shipping charges, etc.), translated into dollars at the then current rate of exchange between the dollar and the pound sterling ($4.04). But when Brown Shipley paid in pounds sterling the amounts of the sight drafts drawn on it by Mair & Company, pursuant to the letters of credit, Brown Brothers Harriman came immediately under an obligation to reimburse Brown Shipley the amounts of the pounds sterling thus paid; and petitioner, under its contract arrangements with Brown Brothers Harriman, came under an immediate corresponding obligation to supply Brown Brothers Harriman with enough dollars at the then current rate of exchange ($4.04) to enable Brown Brothers Harriman to reimburse Brown Shipley in pounds sterling. If petitioner, not having sufficient dollars to satisfy this obligation immediately, had borrowed the requisite dollars on 120-day promissory notes, and had used these borrowed dollars to satisfy its obligation to Brown Brothers Harriman, the petitioner would then not have stood to gain or lose by any supervening change in the dollar-pound sterling exchange rate during the 120-day interval. But petitioner did not do that. Instead, it satisfied its obligation to Brown Brothers Harriman by persuading Brown Shipley to accept a series of drafts at 120 days sight, drawn and endorsed in blank by petitioner, and payable in London in pounds sterling. By this arrangement, petitioner necessarily involved itself in a speculation in foreign exchange. As things turned out, petitioner gained by the speculation, for the devaluation of the pound sterling on September 18, 1949, enabled petitioner, when the 120-day sight drafts became due, to purchase the necessary covering pounds sterling for $84,047.36 less than would have been the case had the exchange rate remained constant. Considering the all-embracing definition of "gross income" § 22(a) of the Internal Revenue Code, it seems to us that this windfall item of $84,047.36, entered in petitioner's

books as "Other Income" for the taxable year, is even more obviously taxable income than was the balance sheet improvement held taxable in *United States v. Kirby Lumber Co.,* 284 U.S. 1 (1931).

In its corporate income tax return for the year in question, petitioner rejected the first of the two alternatives suggested above; it reported its costs for the lambskin purchases figured on the basis of the higher, old exchange rate of $4.04. In the stipulation of facts which the Commissioner and the taxpayer joined in submitting to the Tax Court, it was agreed that the costs of the skins, thus computed, were correctly reported in petitioner's income tax return. In view of the stipulation, we shall assume, for purposes of the present case, that this was so. But, as the Tax Court held, and, in accordance with the second of the above alternatives, that leaves petitioner taxable on the item of $84,047.36 representing petitioner's gain during the taxable year on its speculation in foreign exchange, as above explained.

Before us, as before the Tax Court, petitioner put itself in the impossible position of asking to have it both ways. As stated by Judge Murdock in the opinion of the Tax Court, petitioner wants to use the amount representing what it would have paid for the skins in dollars at the exchange rate of $4.04 "had it not borrowed from or through Shipley, as the cost of the skins to it, but it does not want to report as income the difference between that amount and the smaller number of dollars which it used to pay off the loans."

We have treated the case as one of first impression, for we are aware of no authoritative precedent which we would be obliged to follow. The only case in the Supreme Court which might be thought to be remotely relevant is *Bowers v. Kerbaugh-Empire Co.,* 271 U.S. 170 (1926), a frequently criticized and not easily understood decision. In that case the corporate taxpayer, prior to World War I, had borrowed money from a bank in Germany, repayable in marks. The marks so borrowed were immediately converted into dollars and advanced by the taxpayer to a wholly owned domestic subsidiary for the performance of certain construction contracts. The business enterprise of the subsidiary was unsuccessful and the full amount of the advances from the parent corporation was lost. Subsequently, after the great depreciation in the value of the mark following World War I, the corporate taxpayer applied the necessary dollars to purchase devalued marks with which it repaid the earlier loan. The Supreme Court held, that the difference resulting from the fall of the mark between the amount borrowed and the amount repaid, in American money, was not taxable as income since the "result of the whole transaction was a loss." (P. 175) The Court pointed out that the loss "was less than it would have been if marks had not declined in value; but the mere diminution of loss is not

gain, profit or income." We think the rationale of *Bowers v. Kerbaugh-Empire Co.* is not applicable to the case at bar, since the present taxpayer has made no contention that the net result of its transaction in purchasing lambskins with borrowed foreign exchange was a loss greater than the income realized by reason of petitioner's profitable repayment of the loan, or even any loss at all. The stipulation of facts, which was all the evidence there was before the Tax Court, is silent on how the entire lambskin transaction ultimately resulted with respect to profit or loss. The other cases cited to us are all decisions of the Tax Court. We shall not undertake to analyze them in detail or to reconcile them. They are considered at length in the majority and concurring opinions in the Tax Court. Whether or not the Tax Court decisions enunciate with sufficient clarity and consistency the guiding principles to be applied in this field of the tax law, we are satisfied that the decision of the Tax Court in the present case was clearly right.

The decision of the Tax Court is affirmed.

Notes

(A) Does the court adequately articulate its reasoning? Does it help to say that the taxpayer engaged in "speculation in foreign exchange"? Did the taxpayer speculate in foreign exchange? Did it do anything more than discharge its obligation—to pay pounds sterling—at its face value, that is, by paying the number of pounds sterling it owed? Did all persons who owed debts in England have income when they were able to pay them off with the use of fewer dollars after devaluation?

Suppose the exchange rate had gone the other way, and the taxpayer had needed more dollars than he expected to buy the pounds with which to discharge his sterling obligation? Would he have had a loss when he paid the number of pounds he owed?

There is a comment on the case in 68 Harv.L.Rev. 717 (1955).

See also "The Separate Tax Treatment of Import Transactions and Related Foreign Exchange Fluctuations: The Case for Integration," 68 Yale L.J. 497 (1959); Raffel, "Some Tax Aspects of Foreign Currencies," 14 Tax L.Rev. 389 (1959).

(B) Compare *Church's English Shoes, Ltd. v. Commissioner,* 229 F.2d 957 (C.A.2d, 1956), where the taxpayer imported merchandise from England. It bought goods when the pound was worth $4.86, but did not then pay for them. It did not borrow any pounds, but bought the goods entirely on credit. It carried $12,063.30 on its books as an account payable. Later, the pound was devalued to $4.03, and the taxpayer used $10,000 to discharge its debt. It was held that the gain was ordinary income and not capital gain. The taxpayer did not sell or exchange a capital asset.

See also *America-Southeast Asia Company,* 26 T.C. 198 (1956) (no capital gain on theory of short sale of foreign exchange); "Income Tax Consequences of Fluctuations in Foreign Exchange," 1955 U. of Ill.L.Forum 595.

CHAPTER 5

WHOSE INCOME IS IT?

A. GENERAL

LUCAS v. EARL

Supreme Court of the United States, 1930. 281 U.S. 111.

MR. JUSTICE HOLMES delivered the opinion of the Court.

This case presents the question whether the respondent, Earl, could be taxed for the whole of the salary and attorney's fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife which we shall mention. The Commissioner of Internal Revenue and the Board of Tax Appeals imposed a tax upon the whole, but their decision was reversed by the Circuit Court of Appeals, 30 F.2d 898. A writ of certiorari was granted by this court.

By the contract, made in 1901, Earl and his wife agreed "that any property either of us now has or may hereafter acquire . . . in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds, issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship." The validity of the contract is not questioned, and we assume it to be unquestionable under the law of the State of California, in which the parties lived. Nevertheless we are of opinion that the Commissioner and Board of Tax Appeals were right.

The Revenue Act of 1918 approved February 24, 1919, c. 18, secs. 210, 211, 212(a), 213(a), 40 Stat. 1057, 1062, 1064, 1065, imposes a tax upon the net income of every individual including "income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid," sec. 213(a). The provisions of the Revenue Act of 1921, c. 136, 42 Stat. 227, in sections bearing the same numbers are similar to those of the above. A very forcible argument is presented to the effect that the statute seeks to tax only income beneficially received, and that taking the question more technically the salary and fees became the joint property of Earl and his wife on the very first instant on which they were received. We well might hesitate upon the latter proposition, because however the matter might stand between husband and wife he was the only

party to the contracts by which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone. But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Judgment reversed.

The CHIEF JUSTICE took no part in this case.

Notes and Problems

Personal Services

(A) A performed services for which he was entitled to compensation. Thereafter he became bankrupt, and the compensation was paid to his trustee in banktrupcy. Is the compensation taxable as income to A? See *Packford v. Commissioner,* 133 F.2d 249 (C.C.A.9th, 1943), cert. den. 319 U.S. 741 (1943).

Sale of Property

(B) In *Griffiths v. Commissioner,* 308 U.S. 355 (1939), the taxpayer having arranged to sell certain shares at a profit of $100,000, transferred the shares to a wholly owned corporation. The corporation agreed to pay the price received for the shares to the taxpayer in annual installments over forty years. The corporation transferred the shares and received the payment of $100,000. The taxpayer's contention that he was not taxable except as he received the installments from the corporation was rejected, the Court saying (p. 357): ". . . a lawyer's ingenuity devised a technically elegant arrangement whereby an intricate outward appearance was given to the simple sale from Griffiths to Lay and the passage of money from Lay to Griffiths. That was the crux of the business to Griffiths, and that is the crux of the business to us." There are comments in 52 Harv.L. Rev. 1179 (1939); 38 Mich.L.Rev. 1359 (1940).

Rent

(C) The owner of land assigned to his mother a specified amount "out of my share of the rents" from the property. The amount so assigned was paid to the mother. To whom was it taxable? *Bing v. Bowers,* 22 F.2d 450 (S.D.N.Y.1927), aff'd 26

F.2d 1017 (C.C.A.2d, 1928). But see *Lum v. Commissioner,* 147 F.2d 356 (C.C.A.3d, 1945).[1]

(D) The taxpayer was the owner of the Maywood Race Track, near Chicago. On February 26, 1946, he entered into a twenty-year lease with a trotting association. The rental fixed under this lease was (1) $35,000 per year, plus (2) a percentage of the amount "wagered on said premises" in each calendar year. The lease provided that this latter amount should be paid 40 per cent to the taxpayer, and 20 per cent to each of his three adult sons. Under this provision, $23,923.83 was paid to the sons during 1946. The court held that the amount so paid was taxable to the father. *Galt v. Commissioner,* 216 F.2d 41 (C.A.7, 1954).

(The gift tax question arising from this transaction is set out at p. 985, below.)

Gift of Expected Receipt

(E) In *Riebe v. Commissioner,* 41 B.T.A. 935 (1940), aff'd 124 F.2d 399 (C.C.A.6th, 1941), the holder of a sweepstakes ticket made an oral assignment of a two-thirds interest to members of his family, after the ticket was drawn but before the race was won; and the money was paid accordingly. Was it taxable to the transferees or to the transferors?

See also *Tavares v. Commissioner,* 275 F.2d 369 (C.A.1st, 1960), where a husband made a written assignment of a half interest in a sweepstake ticket to himself and his wife jointly. The wife was a non-resident alien. The ticket won, and the husband received $70,000. He never made any payment to his wife, though he did put some money in a joint account, retaining the pass-book himself. The court held that the entire $70,000 was taxable to the husband.

(F) A majority stockholder in a corporation filed with the corporation formal waiver of his right to receive future dividends. Dividends were thereafter declared and paid. These went to the minority stockholders, who were relatives of the majority stockholder, and employees of the company. The Treasury ruled that he realized income on the payment of the dividend to the extent of his proportion of the total amount of dividends paid. Rev.Rul. 56–431, 1956–2 Cum.Bull. 171. Did the majority stockholder make a gift? If so, when? Cf. *Galt v. Commissioner, supra.*

Transfer of Interest in a Trust

(G) A woman left her residuary estate on trust for her husband for life, remainder to trustees for her children. The husband assigned all of the income to the children. Is the income taxable to him? See *Lowery v. Helvering,* 70 F.2d 713 (C.C.A. 2d, 1934). See also *Commissioner v. Field,* 42 F.2d 820 (C.C.A. 2d, 1930). Suppose that the assignor's interest in the income was subject to a spendthrift trust. See *Commissioner v. Blair,* 60 F.2d 340 (C.C.A.7th, 1933), cert. den. 288 U.S. 602 (1933), noted in 81 U. of Pa.L.Rev. 480 (1933); and the sequel to this case in *Blair v. Commissioner,* 300 U.S. 5, (1936).

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[1] See Schlosberg, "Income Tax Consequences of the Assignment or Cancellation of a Leasehold," 10 Tax L.Rev. 257 (1955).

(H) A was the life beneficiary of a trust. In December, 1929, she assigned to her children specified amounts from the income of the trust for the following year. The Court held that the income was taxable to the assignor, saying that the transfer involved "no such substantial disposition of the trust property as to camouflage the reality that [the transferor] is enjoying the benefit of the income from the trust of which he continues to be the beneficiary . . ." *Harrison v. Schaffner,* 312 U.S. 579 (1941). See "Taxability of Beneficiary-Assignor on Assignments of Trust Income," 50 Yale L.J. 512 (1941).

Where the assignment is for a period of ten years or more, "the lifetime income beneficiary will be considered to have made a disposition of a substantial interest in the trust property," and the income will be taxable to the assignee. Rev.Rul. 55–38, 1955–1 Cum.Bull. 389.

(I) See, generally, Surrey, "Assignments of Income and Related Devices," 33 Col.L.Rev. 791 (1933); Bowden, "Assignments of Income Reconsidered," 20 Taxes 67 (1942).

Patents and Copyrights

(J) Difficult questions arise with respect to patents and copyrights. A sale or a gift of the entire interest in the patent or copyright transfers the property, and, in the absence of special circumstances, the income is thereafter taxable to the transferee. On the other hand, a license of the patent or copyright may produce royalties which are taxable as ordinary income, like rent. In between, are a number of possible arrangements, and there may be considerable difficulty in telling whether the transaction is a sale or gift, or a license with royalty reserved. In recent years there has been a tendency to hold that patents and copyrights are divisible, and that exclusive rights to use the patent in a particular area, or to use the copyright in a particular medium, as for a book, for the radio, or for motion pictures, for the life of the patent or copyright, may be granted or given away without leaving the transferor taxable on the income from this part of the property. See, for example, Rev.Rul. 54–409, 1954–2 Cum.Bull. 174, and Rev.Rul. 54–599, 1954–2 Cum.Bull. 52. See also the consideration of this question at pages 585–586, 588–589, below, in the material on sale or exchange.

In *Commissioner v. Reece,* 233 F.2d 30 (C.A.1st, 1956), the taxpayer owned a royalty contract which he had obtained on the sale of a patent. He gave the contract to another person, with no strings of any sort reserved. It was held that the income was taxable to the transferee.

The Ct will look beyond the transaction to determine its true relationship & its legality.

JONES v. PAGE

Circuit Court of Appeals, Fifth Circuit, 1939. 102 F.2d 144.
Certiorari denied 308 U.S. 562 (1939).

FOSTER, CIRCUIT JUDGE. The Commissioner determined deficiencies in income taxes of appellant, Robert T. Jones, for the years 1931 and 1933, of $27,396.73 and $25,942.64 respectively. Appellant paid the taxes and brought suit against the Collector

to recover. The case was tried by the judge without the intervention of a jury and resulted in a judgment for defendants.

The following material facts are not in dispute: On November 13, 1930, appellant entered into a contract with Warner Brothers, Inc. to make a series of moving pictures, depicting his form and style in playing golf. The agreement provided that he should receive compensation in the sum of $120,000, with a royalty of 50 per cent of the net receipts from the distribution and sale of the pictures. Of this sum $20,000 was paid to him in advance. After that, on February 24, 1931, before he commenced to make the pictures, appellant entered into a contract to sell his services to his father, Robert P. Jones, for the term of six years at $1,000 per year and transferred his rights under his existing contract with Warner Brothers, Inc., to his father. His father accepted the contract and transferred his rights thereunder to himself as trustee for appellant's three minor children. Three trusts in favor of the children were executed. On March 4, 1931, prior to the making of any pictures, an agreement was made between Warner Brothers, Inc. and appellant's father, by which the original contract was cancelled and another contract was made between Robert P. Jones, the father, as trustee, and Warner Brothers, Inc., for the services of appellant, on terms substantially the same as the original contract. Contemporaneously with this contract appellant executed a collateral agreement with Warner Brothers, Inc., to guarantee he would perform the acts and duties for which his father had contracted. Appellant's services were rendered according to the contract with his father, payment was made to the father as trustee and to the Trust Co. of Georgia, pursuant to a letter of instruction.

Conceding that a taxpayer has the right to decrease the amount of his taxes or to avoid them by legal means, in every instance where that is attempted, a court may look through the transaction and determine whether it is legal or violates the intent of the statute. It would be absurd to say that any reasonable man having a contract from which he was to receive a minimum of $100,000 would in good faith transfer it to another for merely $6,000. Appellant could have set up the trust in favor of his children without the intervention of his father. The conclusion is inescapable that he used his father simply as a conduit in an attempt to reduce or avoid taxes that would be otherwise assessable against compensation derived from his own personal services. The plan adopted was without legal effect and the taxes complained of were properly assessed against appellant under the provisions of Sections 11, 21 and 22(a) of the Revenue Acts of 1928 and 1932. We are not aware of any controlling authority exactly in point as applied to the facts in this case but the following decisions state the principle that governs. *Gregory v. Helvering,*

293 U.S. 465; *Minnesota Tea Co. v. Helvering,* 302 U.S. 609; *Esperson v. Commissioner,* 5 Cir., 49 F.2d 259; *Atkins v. Commissioner,* 5 Cir., 76 F.2d 387; *Saenger v. Commissioner,* 5 Cir., 69 F.2d 631. Many other cases might be cited but it is unnecessary to do so.

The judgment appealed from is

Affirmed.

Problems

(A) The taxpayer, an actor, organized a corporation of which he owned all the shares, except directors' qualifying shares. He then entered into a contract with the company for his exclusive services for a period of five years at a salary considerably less than the company received for his services from motion picture producers. There was evidence that the directors were independent business men who were not dominated by the taxpayer, and that it was planned that the company would itself engage in motion picture production when it had accumulated sufficient capital. Were the amounts received by the corporation for the taxpayer's services taxable as income to him? *Commissioner v. Laughton,* 113 F.2d 103 (C.C.A.9th, 1940).

In this connection, it should be noted that "Amounts received under a contract under which the corporation is to furnish personal services" are now included within the definition of personal holding company income for the purpose of the additional income tax on personal holding companies. Sec. 543(a)(5) of the 1954 Code. See Dean, "Decadence of the Corporate Device as a Means of Avoiding Surtaxes on Individuals," 15 Temple L.Q. 65 (1940).

(B) The taxpayer was president and a director of a large corporation. By a resolution of the Board, his compensation was fixed at 5% of the net profits. On July 22, 1927, the taxpayer notified the Board of Directors that he would not accept any further compensation for the year 1927, and "suggested that the corporation do something worthwhile with the money." On January 20, 1928, the Board adopted a resolution reciting that the taxpayer was entitled to $1,500,000, that he refused to take it, and directing that that amount be paid to the University of California to establish a Foundation of Agricultural Economics. It was expressly provided that the Foundation should be named after the taxpayer. Was the taxpayer subject to income tax on the amount so paid? *Commissioner v. Giannini,* 129 F.2d 638 (C.C.A.9th, 1942).

HELVERING v. HORST

Supreme Court of the United States, 1940. 311 U.S. 112.

MR. JUSTICE STONE delivered the opinion of the Court.

The sole question for decision is whether the gift, during the donor's taxable year, of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor.

In 1934 and 1935 respondent, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity. The Commissioner ruled that under the applicable § 22 of the Revenue Act of 1934, 48 Stat. 680, 686, the interest payments were taxable, in the years when paid, to the respondent donor who reported his income on the cash receipts basis. The circuit court of appeals reversed the order of the Board of Tax Appeals sustaining the tax. 107 F. 2d 906; 39 B.T.A. 757. We granted certiorari, 309 U.S. 650, because of the importance of the question in the administration of the revenue laws and because of an asserted conflict in principle of the decision below with that of *Lucas v. Earl,* 281 U.S. 111, and with that of decisions by other circuit courts of appeals. See *Bishop v. Commissioner,* 54 F.2d 298; *Dickey v. Burnet,* 56 F.2d 917, 921; *Van Meter v. Commissioner,* 61 F.2d 817.

The court below thought that as the consideration for the coupons had passed to the obligor, the donor had, by the gift, parted with all control over them and their payment, and for that reason the case was distinguishable from *Lucas v. Earl, supra,* and *Burnet v. Leininger,* 285 U.S. 136, where the assignment of compensation for services had preceded the rendition of the services, and where the income was held taxable to the donor.

The holder of a coupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons. Together they are an obligation to pay principal and interest given in exchange for money or property which was presumably the consideration for the obligation of the bond. Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others which constituted an economic gain to him.

Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining "realization" of income as the taxable event rather than the acquisition of the right to receive it. And "realization" is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is

taken by which he obtains the fruition of the economic gain which has already accrued to him. *Old Colony Trust Co. v. Commissioner,* 279 U.S. 716; *Corliss v. Bowers,* 281 U.S. 376, 378. Cf. *Burnet v. Wells,* 289 U.S. 670.

In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. Cf. *Aluminum Castings Co. v. Routzahn,* 282 U.S. 92, 98. This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. The question here is, whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him see *Old Colony Trust Co. v. Commissioner, supra; Bowers v. Kerbaugh Empire Co.,* 271 U.S. 170; *United States v. Kirby Lumber Co.,* 284 U.S. 1, or if he sets up a revocable trust with income payable to the objects of his bounty, §§ 166, 167, Revenue Act of 1934, *Corliss v. Bowers, supra;* cf. *Dickey v. Burnet,* 56 F.2d 917, 921, he does not escape taxation because he did not actually receive the money. Cf. *Douglas v. Willcuts,* 296 U.S. 1; *Helvering v. Clifford,* 309 U.S. 331.

Underlying the reasoning in these cases is the thought that income is "realized" by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. Cf. *Burnet* v. *Wells, supra.*

Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself he has

nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named. *Burnet v. Wells, supra.*

In a real sense he has enjoyed compensation for money loaned or services rendered and not any the less so because it is his only reward for them. To say that one who has made a gift thus derived from interest or earnings paid to his donee has never enjoyed or realized the fruits of his investment or labor because he has assigned them instead of collecting them himself and then paying them over to the donee, is to affront common understanding and to deny the facts of common experience. Common understanding and experience are the touchstones for the interpretation of the revenue laws.

The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it. We have had no difficulty in applying that proposition where the assignment preceded the rendition of the services, *Lucas v. Earl, supra; Burnet v. Leininger, supra,* for it was recognized in the *Leininger* case that in such a case the rendition of the service by the assignor was the means by which the income was controlled by the donor and of making his assignment effective. But it is the assignment by which the disposition of income is controlled when the service precedes the assignment and in both cases it is the exercise of the power of disposition of the interest or compensation with the resulting payment to the donee which is the enjoyment by the donor of income derived from them.

This was emphasized in *Blair v. Commissioner,* 300 U.S. 5, on which respondent relies, where the distinction was taken between a gift of income derived from an obligation to pay compensation and a gift of income-producing property. In the cir-

cumstances of that case the right to income from the trust property was thought to be so identified with the equitable ownership of the property from which alone the beneficiary derived his right to receive the income and his power to command disposition of it that a gift of the income by the beneficiary became effective only as a gift of his ownership of the property producing it. Since the gift was deemed to be a gift of the property the income from it was held to be the income of the owner of the property, who was the donee, not the donor, a refinement which was unnecessary if respondent's contention here is right, but one clearly inapplicable to gifts of interest or wages. Unlike income thus derived from an obligation to pay interest or compensation, the income of the trust was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm had been given away. *Blair v. Commissioner, supra,* 12, 13 and cases cited. See also *Reinecke v. Smith,* 289 U.S. 172, 177. We have held without deviation that where the donor retains control of the trust property the income is taxable to him although paid to the donee. *Corliss v. Bowers, supra.* Cf. *Helvering v. Clifford, supra.*

The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. See, *Corliss v. Bowers, supra,* 378; *Burnet v. Guggenheim,* 288 U.S. 280, 283. The tax laid by the 1934 Revenue Act upon income "derived from . . . wages or compensation for personal service, of whatever kind and in whatever form paid, . . . ; also from interest . . . " therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received.

It is the statute which taxes the income to the donor although paid to his donee. *Lucas v. Earl, supra; Burnet v. Leininger, supra.* True, in those cases the service which created the right to income followed the assignment and it was arguable that in point of legal theory the right to the compensation vested instantaneously in the assignor when paid although he never received it; while here the right of the assignor to receive the income antedated the assignment which transferred the right and thus precluded such an instantaneous vesting. But the statute affords no basis for such "attenuated subtleties." The distinction was explicitly rejected as the basis of decision in *Lucas v. Earl.* It should be rejected here, for no more than in the *Earl* case can the purpose of the statute to tax the income to him who earns, or creates and enjoys it be escaped by "antic-

ipatory arrangements however skilfully devised" to prevent the income from vesting even for a second in the donor.

Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions. The owner of a negotiable bond and of the investment which it represents, if not the lender, stands in the place of the lender. When, by the gift of the coupons, he has separated his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings and in both cases the import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew. See *Lucas v. Earl, supra,* 115.

Reversed.

The separate opinion of MR. JUSTICE MCREYNOLDS.

The facts were stipulated. In the opinion of the court below the issues are thus adequately stated—

"The petitioner owned a number of coupon bonds. The coupons represented the interest on the bonds and were payable to bearer. In 1934 he detached unmatured coupons of face value of $25,182.-50 and transferred them by manual delivery to his son as a gift. The coupons matured later on in the same year, and the son collected the face amount, $25,182.50, as his own property. There was a similar transaction in 1935. The petitioner kept his books on a cash basis. He did not include any part of the moneys collected on the coupons in his income tax returns for these two years. The son included them in his returns. The Commissioner added the moneys collected on the coupons to the petitioner's taxable income and determined a tax deficiency for each year. The Board of Tax Appeals, three members dissenting, sustained the Commissioner, holding that the amounts collected on the coupons were taxable as income to the petitioner."

The decision of the Board of Tax Appeals was reversed and properly so, I think.

The unmatured coupons given to the son were independent negotiable instruments, complete in themselves. Through the gift they became at once the absolute property of the donee, free from the donor's control and in no way dependent upon ownership of the bonds. No question of actual fraud or purpose to defraud the revenue is presented.

Neither *Lucas v. Earl,* 281 U.S. 111, nor *Burnet v. Leininger,* 285 U.S. 136, support petitioner's view. *Blair v. Commissioner,* 300 U.S. 5, 11, 12, shows that neither involved an unrestricted completed transfer of property.

Helvering v. Clifford, 309 U.S. 331, 335, 336, decided after the opinion below, is much relied upon by petitioner, but involved facts very different from those now before us. There no separate thing was absolutely transferred and put beyond possible control by the transferor. The court affirmed that Clifford, both conveyor and trustee, "retained the substance of full enjoyment of all the rights which previously he had in the property." "In substance his control over the corpus was in all essential respects the same after the trust was created as before." "With that control in his hands he would keep direct command over all that he needed to remain in substantially the same financial situation as before."

The general principles approved in *Blair v. Commissioner,* 300 U.S. 5, are applicable and controlling. The challenged judgment should be affirmed.

The CHIEF JUSTICE and MR. JUSTICE ROBERTS concur in this opinion.

Notes

(A) But see *Commissioner v. Williston,* 315 Mass. 648, 54 N.E. 2d 43 (1944), *contra.*

On the general topic, see Soll, "Intra-Family Assignments: Attribution and Realization of Income." 6 Tax.L.Rev. 435, 7 Tax L.Rev. 61 (1951).

(B) Is the *Horst* case right in saying that the income is taxable in the period when the coupon is collected? Is it arguable that the donor should be taxable on the fair market value of the coupon on the date of gift, or on the accrued income on the bond at that time (which is a different amount from the fair market value of the coupon—why?), and that the tax on this item should be payable for the period in which the gift is made?

(C) On the day the *Horst* case was decided, the Supreme Court decided *Helvering v. Eubank,* 311 U.S. 122 (1940). In this case, the taxpayer had been a general agent for a life insurance company. After the termination of his agency, he made assignments of portions of the renewal commissions which would thereafter become payable to him for his services in writing policies. The Court held that the commissions were taxable to the assignor.[1]

The application of this principle may be seen in such situations as the following:

A surgeon each year transferred to a trust created for the benefit of his minor child certain accounts receivable arising out of the practice of his profession. The transfers were irrevocable; there was an independent trustee. It was ruled that when

1 See Shattuck, "Taxation of Deflected Income—The Horst and Eubank Cases," 13 Rocky Mountain L.Rev. 220 (1941); Barrett, "Taxing Assigned Income Under Helvering v. Horst," 29 Calif.L.Rev. 495 (1941); Bowden, "Assignments of Income Reconsidered," 20 Taxes 67 (1942); Harrown, "Helvering v. Horst: Some Notes on Recent Application of the Doctrine," 6 N.Y.U. Inst.Fed.Taxation 1127 (1948).

the amounts were collected by the trustee they were taxable to the grantor. Rev.Rul. 55–2, 1955–1 Cum.Bull. 211.

(D) Suppose that in the *Eubank* case the future renewal commissions had been *sold* for a fair price paid in a lump sum. When the commissions were thereafter paid to the assignee, to whom would they be taxable? If taxable to the assignee, is he entitled to any deduction for amortization of the price he paid? Is the purchase price paid to the assignor taxable to him in full as ordinary income? See *Cotlow v. Commissioner,* 228 F.2d 186 (C.A.2d, 1955).

(E) In *Estate of Anthony v. Commissioner,* 155 F.2d 980 (C.C. A.10th, 1946), income from oil operations was impounded pursuant to a court order, resulting from a creditor's claim. While it was impounded the donor made a gift of it. When it was released and paid to the donee, it was held to be income to the donor.

(F) A bank held certain notes which it had previously charged off as worthless. In 1942, it appeared that these might be collected. The directors then declared the notes as a dividend to its shareholders. The debtors were not notified of the assignment. The notes were thereafter paid, payment being made through the bank. It was held that the amount collected on the notes was income to the bank. *Commissioner v. First State Bank of Stratford,* 168 F.2d 1004 (C.C.A.5th, 1948), cert. den. 335 U.S. 867 (1948). See also *Fairfield Steamship Corp. v. Commissioner,* 157 F.2d 321 (C.C.A.2d, 1946); *Commissioner v. Transport Trading & Terminal Corp.,* 176 F.2d 570 (C.A.2d, 1949).

See Molloy, "Some Tax Aspects of Corporate Distributions in Kind," 6 Tax L.Rev. 57 (1950).

(G) Other applications of this important principle, are shown in the following cases:

In *United States v. Lynch,* 192 F.2d 718 (C.A.9th, 1951), cert. den. 343 U.S. 934 (1952), a corporation in the fruit business distributed to its shareholders as a dividend its entire inventory of apples. The apples were kept in the corporation's warehouse, and the three shareholders, entered into a contract with the corporation for the latter to sell and distribute the apples for the shareholders' accounts. The apples were all sold a few weeks later. It was held that the gain on the sale of the apples was taxable to the corporation. The court said: "The shareholders, under the circumstances of this case, cannot avoid payment of the price Congress has decreed must be paid for the use of the corporate entity."

In *Floyd v. Scofield,* 193 F.2d 594 (C.A.5th, 1952), a corporate taxpayer, on the cash basis, sold inventory property on credit. Then the accounts receivable resulting from the sales were assigned to the shareholders in liquidation. The accounts were collected by agents for the stockholders. It was held that the income was taxable to the corporation, and that the stockholders were liable as transferees for the corporate tax.

A corporation on the accrual basis was liquidated, having then outstanding certain commissions on goods sold for others. These commissions had not yet been taken into its income, as the goods had not been shipped. On liquidation, the right to receive the commissions was transferred to the corporation's sole stock-

holder. He collected them while the corporation was still in the process of liquidation. It was held that the amount collected was income to the corporation. *J. Ungar, Inc. v. Commissioner,* 244 F.2d 90 (C.A.2d, 1957).

(H) A case looking the other way, on rather complicated facts, is *Cold Metal Process Co. v. Commissioner,* 247 F.2d 864 (C.A. 6th, 1957). The major assets of a corporation were patents, and a law suit for royalties under the patents, in which the validity of the patents was denied. It was highly uncertain that the corporation would ever collect, although a large sum had been paid into an impounded fund awaiting the result of the law suit. In 1945, the corporation was dissolved, and all assets were transferred to a trustee for shareholders. A large part of the shares were held by a charity. In 1949, there was a favorable decision in the law suit, and the impounded funds were then paid to the trustee for shareholders. The court rejected the Commissioner's claim that the amount paid in 1949 constituted income to the corporation in that year. There is a comment on the case in 44 Va.L.Rev. 123 (1958).

Gifts to Charities

Suppose the assignment of compensation for services is made to a charity. Is the compensation nevertheless taxable to the assignor? Does it make any difference, since charitable gifts are deductible? See Hearings Before the Joint Committee on Tax Evasion and Avoidance, 75 Cong., 1st Sess. (1937) 425–440, involving the case of Mrs. Roosevelt, who was advised by the Treasury that she was not taxable on compensation received for radio broadcasts which she donated to charity. This view has now been repudiated by the Treasury. See T.D. 5151, 1942–1 Cum.Bull. 34, adding the material which now appears as sec. 1.61–2(c) of the Income Tax Regulations.

Consider the two following rulings:

In Rev.Rul. 58–495, 1958–2 Cum.Bull. 27, it appeared that a group of employees agreed to donate one hour's pay per day for a period of five days to a charity. Under the arrangement, the employer made payment direct to the charity, and the employees received no pay for the periods. It was ruled that the amounts were gross income to the employees, and were subject to withholding.

In Rev.Rul. 58–515, 1958–2 Cum.Bull. 28, a police officer was assigned to work in a private industrial plant, in order to investigate suspected crime. Under the rules of the police department, he received his regular police pay during this period, and remitted the pay he received from the industrial plant to the Police Pension Fund. It was ruled that the amount he received from the industrial plant was not includible in gross income, since he "was employed in private industry as an agent of the police department."

Are the two rulings consistent?

REVENUE RULING 71

Bureau of Internal Revenue, 1953. 1953–1 Cum.Bull. 18.

Advice has been requested relative to circumstances in which the second sentence of the last paragraph of section 29.22(a)–2 of Regulations 111 will apply. The first and second sentences of such paragraph are as follows:

> The value of services need not be included in gross income when rendered directly and gratuitously to an organization described in section 23(*o*). Where, however, pursuant to an agreement or understanding services are rendered to a person for the benefit of an organization described in section 23(*o*) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services even though at the time of the agreement or understanding the person making the payment acknowledges his liability to make payment to such organization.

The typical case in which the second sentence of the above paragraph is applicable is one in which a radio sponsor or motion picture producer engages the services of an artist and by agreement with the artist turns over the payment for those services to a charitable organization designated by the artist.

Instances also arise in which an artist enters into an agreement with a charitable organization to render services to it, and the charitable organization in turn agrees with a sponsor or producer to make those services available to such sponsor or producer in consideration of a sum to be paid to the charitable organization. Such an arrangement often constitutes an attempt, by act of the parties, to channel to an exempt organization income which would normally be that of the individual artist and thereby to avoid the percentage limitation on the deduction of charitable contributions provided in section 23(*o*) of the Code. In such situation the tax consequences will be the same as those attending the type of transaction described in the preceding paragraph. The rule that income is taxable to the one who earns it cannot be avoided by such an anticipatory arrangement.

Thus, for example, if an actor, whose contract with the studio regularly employing him permits, enters into a contract with a university, under which the actor may or may not have nominal duties at the university but in fact renders services principally to a third party, such as a radio sponsor or motion picture producer, payment for his services to be made to the university, such an arrangement constitutes an attempt to do indirectly the same thing that is done in the typical case hereinabove described. Ac-

cordingly, it is held that in such circumstances the sums paid to the charitable organization are includible in gross income of the individual rendering the services.

There are instances, however, in which an individual is under contract of employment or other obligation entered into in good faith for purposes other than avoidance of the percentage limitation imposed on the deduction of contributions by section 23(*o*) of the Code, and, as an incident of his normal duties and obligations, his employer or other superior makes his services available to a third party, payment being made to the employer or other superior. In such a case, if the individual does not participate directly or indirectly in the contract pursuant to which his services are made available to the third party and if he has no right to receive, or direct the use or disposition of, the amounts so paid, such amounts are not includible in his gross income. This conclusion would be the same whether the employer or other superior having control of the services is a commercial organization or an organization described in section 23(*o*) of the Code. However, it must be clearly shown that the relationship was entered into in good faith for purposes other than avoidance of the percentage limitation imposed by section 23(*o*) on deduction of contributions, and that the organization is entitled, in substance as well as form, to the services which it makes available to the third party. The execution of a legally sufficient contract of employment or other document purporting to establish the obligation contemplated is a fact with evidentiary value, but is not necessarily dispositive of any case. Good faith and reality are not ascertained by any mechanical or formalistic test. The effect for tax purposes of the contract of employment or other obligation will be determined by a consideration of all the circumstances.

Notes

(A) See also G.C.M. 27026, 1951–2 Cum.Bull. 7, dealing with the taxability of proceeds derived from public entertainments conducted for the benefit of charitable organizations—so-called "benefit" performances. It was ruled that where a person in the business of promoting sporting events or other public entertainments puts on a performance for charity, even when acting as agent for the charitable enterprise, the amounts are includable in the promoter's gross income, since "the promoter is in effect assigning to the charitable organization earnings derived by him from the operation of the event." It was recognized, however, that the charity might itself be the promoter of the event, and might use facilities lent for the purpose, without resulting in any tax on the lender.

(B) Note sec. 114 of the 1954 Code, which makes this rule inapplicable to events conducted for the benefit of the Red Cross. This would seem to emphasize its applicability in the case of benefits for other charitable organizations.

CAMPBELL v. PROTHRO

United States Court of Appeals, Fifth Circuit, 1954. 209 F.2d 331.

HUTCHESON, CHIEF JUDGE. The suit was to recover overpayments of income taxes resulting from . . . the inclusion by the commissioner, as ordinary income of plaintiffs for the year 1948, of the fair market value at the date of gift of calves taxpayers had donated to the Wichita Falls Young Men's Christian Association, and it had sold.

The claim . . . was that this treatment by the commissioner was a distortion of plaintiff's income, was in direct contradiction of the facts, and was in violation of the fundamental theory of income tax law that it is essential to the taxation of income that it has been realized by the taxpayer to whom it is proposed to tax it.

[The taxpayer prevailed in the District Court and the collector appealed.]

. . . appellant insists that, because the calves were kept for sale in the ordinary business of the partnership of which Prothro was a member, the expense of raising them had been allowed as deductions, and the proceeds of the calves if sold by taxpayers would have been ordinary income, the case is ruled by *Helvering v. Horst,* 311 U.S. 112, and similar cases, in which it is in effect held that when the right of one to collect income is given to another and that other receives it, the giver is taxable on the income in the same way and to the same extent as he would have been if he had collected the income and then given it to the donee.

Appellant also relies heavily upon two office decisions published by the Bureau of Internal Revenue, viz., I.T. 3910, 1948–1 Cum.Bulletin 15 and I.T. 3932, 1948–2 Cum.Bulletin 7.[1]

Stating: "It is well settled that income is realized by making a gift of it. That is the very essence of the familiar anticipatory assignment of income rule," and citing, in addition to the *Horst* case, cases which have been decided on its authority, appellant goes on to argue:

> "In the present case the gift was of property wholly representing income. As already shown, the calves in the 1948 calf crop of the Perkins-Prothro partnership were not capital assets. Nor were they income-producing property. They were property which was produced and held primarily for sale to customers, which had no cost basis, and which result-

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1 By the first of these rulings the Bureau attempted to hold that income is realized when agricultural products are contributed to a charitable institution. By the second ruling the Bureau took the position that a stock raising farmer realized income when he made an admittedly bona fide gift of some feeder cattle to his son.

ed from expenditures which were wholly deductible and deducted as business operating expenses. The calves represented ordinary income in toto."

Then quoting the two Bureau decisions above referred to, appellant argues that the *Horst* doctrine is just as applicable to the facts of the instant case as to the facts to which this court applied it in *Commissioner of Internal Revenue v. First State Bank of Stratford,* 168 F.2d 1004, . . .

. . . appellees, analyzing and discussing the cases cited by appellant, including the *Horst* case, assert that the transaction in question here is not a *Horst* case transaction, nor is it similar to the transactions dealt with in the other cases appellant cites. Expanding this view, appellees go on to say:

"All of the foregoing cases have one element in common. In each of them prior to the assignment involved, the donor had a vested right to specific proceeds which, when collected, constituted income per se. The assignments involved, in these cases were accordingly held to constitute assignments of income. An additional feature present in First National Bank of Stratford, supra, was the existence of a corporation stockholder relationship, not present here, that further supported the holding of the court in that particular case. *United States v. Joliet & Chicago R. Co.,* 315 U.S. 44.

"The fundamental defect in the Government's position in the case at bar is that the animals here in question did not per se represent 'income'. The plan or scheme of the income taxing acts is that from the realized and recognized gross income of the taxpayers, there is subtracted or withdrawn all deductions allowed by law, and the remaining balance or net taxable income subjected to tax.

" . . . Compensation for personal services and periodical returns from capital investments become 'gross income' when earned, although the time when the taxpayer is required to recognize them, that is report them for taxation, depends on taxpayer's method of accounting. Gains from the sale or exchange of property, on the other hand, do not arise, and therefore do not constitute 'gross income' until a sale or exchange for value has been consummated, regardless of taxpayer's method of accounting.

" . . . raised livestock does not constitute income per se. This is because raised livestock are not claims or demands representing income fully earned but are instead chattels created by the livestock raiser through the instrumentality of his breeding herd and having an independent basis for gain or loss in his hands. . . . Gains from raised animals can only be realized if and when they are sold or disposed of by their owner for value in a taxable

transaction." Citing *Estate of Burnett v. Commissioner of Internal Revenue,* 2 T.C. 897.

We find ourselves in agreement with appellees' views. In the *Horst* case, the father, when the coupons on the bonds involved had become, or were about to become due, gave them to his son who collected them, and the court there properly held that the gift constituted an anticipatory assignment of the interest as income, within the Lucas-Earl rule (*Lucas v. Earl,* 281 U.S. 111). It was not there held, nor has any case cited to or found by us held that if both principal and interest are given, and the principal matures in the year of the assignment, there would be an anticipatory assignment of income as to the principal, so as to make the giver taxable on unrealized appreciation in its value, or on interest accruing in successive years. Indeed, the contrary has been held in *Austin v. Commissioner of Internal Revenue,* 6 Cir., 161 F.2d 666.

Here the facts are entirely different from those of any of the cited cases. Here not interest due on choses in action in the year in which the assignment is made, but calves, chattels, whose value could be realized only by a sale, were given. We have found no case, we have been referred to none holding that unrealized appreciation in the value of cattle given away would be regarded as ordinary income merely because they had no base, were kept for sale in the ordinary course of business, and when sold by the taxpayer would have been ordinary income. Cf. *Visintainer v. Commissioner of Internal Revenue,* 10 Cir., 187 F.2d 519 and *White v. Brodrick,* D.C., 104 F.Supp. 213 to the contrary.

This court in *Commissioner of Internal Revenue v. First State Bank of Stratford,* 5 Cir., 168 F.2d 1004, thus correctly stated, at page 1010, the principle underlying the rationale of the line of cases relied on by the commissioner:

> "Mere unrealized appreciation in the value of property does not constitute taxable income; but this principle is not in conflict with the doctrine announced in the *Horst* and *Eubank* cases, in which unquestionably taxable income was involved. Unrealized appreciation, since it is not taxable income, is not covered by the rule as to anticipatory assignments of income. The latter rule is sui generis; it applies to debts, including bad debts, to the extent that they represent income." . . .

We come back, then, to the point of departure. Were the calves when transferred by gift to the Y.M.C.A. realized income to the appellees in the taxable sense. We think it clear that they were not. If they were, then every appreciation in value of property passing by gift is realized income. We know that this is

not so, and that, though it is and has been the contention of the Bureau that it ought to be, congress has never enacted legislation so providing.

If appellant's position is sustained here, it must be because the calves were already income to the taxpayers. If in their hands the calves were then their income, of course the making of the gift did not change this status. If they were not income in taxpayers' hands, their gift of them could not, in the present state of the law, result in the receipt of income by them. It is true that efforts have been made to procure the enactment of statutes to change the rule that a gift does not make the donor taxable on unrealized appreciation in the value of the property given. Congress has so far not adopted, indeed has declined to adopt that view. Under the statutes as they exist, the court may not do so. The judgment is right. It is affirmed.

RIVES, CIRCUIT JUDGE (dissenting). . . .

Notes

(A) There is a comment on the principal case in 67 Harv.L. Rev. 1425 (1954).

(B) The two rulings cited by the court were as follows:

In I.T. 3910, 1948–1 Cum.Bull. 15, a farmer gave wheat which he had grown on his farm to a charity. The Treasury ruled that the fair market value of the wheat was includible in the farmer's income.

In I.T. 3932, 1948–2 Cum.Bull. 7, a livestock raiser made a bona fide gift to his son of cattle which he had raised and which had a fair market value of $1500 at the time of the gift. The son sold them about eight months later for $2100. The ruling held that the fair market value of the cattle on the date of the gift was includible in the father's gross income in the year in which the gift was made, and that the excess of the selling price over the fair market value at the time of the gift was ordinary income to the son.

The rulings did not meet with favor in the courts. In addition to the principal case, see *Estate of W. G. Farrier,* 15 T.C. 277 (1950); *Visintainer v. Commissioner,* 187 F.2d 519 (C.A.10th, 1952), certiorari denied 342 U.S. 858 (1952); *White v. Brodrick,* 104 F.Supp. 213 (D.Kan.1952).

(C) Thereafter, the Treasury formally revoked I.T. 3910 and I.T. 3932, and discussed the problem generally in two rulings. Rev.Rul. 55–138, 1955–1 Cum.Bull. 223, and Rev.Rul. 55–531, 1955–2 Cum.Bull. 520. The Treasury held that a donor does not derive income when he gives agricultural or manufactured products to charity. The ruling held, however, that no double deduction should be allowed. Where inventory property is given, the cost of the property, or its inventory value, must be eliminated from the inventory. Where agricultural property is given, "Items of cost of the current year applicable to such property are not deductible by the donor, and similar items which have

been deducted in prior years must be removed from the amount of the contribution in order to avoid a double deduction."

This has now been incorporated into sec. 1.170–1(c) of the Income Tax Regulations. See Branscomb, "Gifts and Other Dispositions of Crops," 46 A.B.A.J. 95 (1960).[1]

(D) A similar question has arisen in England, on rather interesting facts. A woman owned a stud farm and a racing stable. The stud farm was a business. The racing stable was a hobby; it lost money, and its transactions could not be taken into account for tax purposes. A horse was bred and raised on the stud farm. It was decided that it would be good for the racing stable, and the horse was accordingly transferred to the racing stable. It was held that the owner had income at this point in the amount of the fair market value of the horse at the time of transfer. In other words, the transaction was treated the same as it would have been if she had sold the horse to an outsider. *Sharkey v. Wernher*, [1956] A.C. 58, noted in 72 L.Q.Rev. 174 (1956).

Taxation of Families—Community Property and Split Income

Most of the questions about assignment of income arise out of efforts to keep income in lower brackets by dividing it up among the several members of a family—without losing control of the source of income.

As far as husbands and wives are concerned, this problem might be eliminated in either of two ways: (1) by requiring them to file joint returns on which their income and tax would be computed as a unit, or (2) by allowing them to file joint returns on which the income of both of them is split into two parts for the purpose of the tax computation, that is, by computing the tax of the two of them as twice the tax on half of their joint income.

The first alternative has long been the rule under the English income tax. For an amusing commentary on this provision, see "Rex v. Merry and Pratt—The Tax on Virtue," in Herbert, Uncommon Law 233 (1936). At various times efforts were made to include a provision for compulsory joint returns in the United States income tax. These efforts were not successful, though some of the opposition seems to have been pitched on unsound ground. Would compulsory joint returns be constitutional? *Cf.*

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[1] The general problem is discussed in "Gratuitous Disposition of Property as Realization of Income," 62 Harv.L.Rev. 1181 (1949). The earlier rulings were criticized in Miller, "Gifts of Income and of Property: What the Horst Case Decides," 5 Tax L.Rev. 1 (1949). See also Griswold, "Charitable Gifts of Income and the Internal Revenue Code," 65 Harv.L.Rev. 84 (1951); Bittker, "Charitable Gifts of Income: Another View," 65 Harv.L.Rev. 1375 (1952); Roehner and Roehner, "Realization: Administrative Convenience or Constitutional Requirement," 8 Tax L.Rev. 173 (1953).

Problems in the general area are discussed in "Farmers and the Federal Income Tax," 19 U. of Chi.L.Rev. 522 (1952); Throckmorton, "Federal Taxation of the Farmer," 34 Iowa L.Rev. 251 (1949).

Hoeper v. Tax Commission, 284 U.S. 206 (1931). See Bruton, "The Taxation of Family Income," 41 YaleL.J. 1172 (1932).

For many years the problem was acute in the United States because of the community property system which had long been in force in eight western and southwestern states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington). In *Poe v. Seaborn,* 282 U.S. 101 (1930), and related cases, the Supreme Court held that the earnings of husband or wife in a community property state were taxable half to each, regardless of who actually earned them. This result was based largely on the construction of the word "of" in the phrase "income of every individual," now found in sec. 1 of the 1954 Code; it was also based in part on the legislative history of efforts to make special provision for community property income. In *United States v. Malcolm,* 282 U.S. 792 (1931), the Court held that the rule was also applicable to community property in California acquired after 1927, when California made some verbal changes in its laws, although the contrary result had been reached in *United States v. Robbins,* 269 U.S. 315 (1926).

The result was a very substantial saving of tax for married persons in the community property states. It is not surprising that other states sought to get the same advantage. In 1939, Oklahoma adopted a community property law. In *Commissioner v. Harmon,* 323 U.S. 44 (1944), this was held to be ineffective because it was optional on the spouses, rather than compulsory. In 1945, Oklahoma adopted a compulsory law. A number of other states followed, including Oregon, Nebraska, Michigan and Pennsylvania; New York and Massachusetts, and numerous others, had the matter under active consideration.

Thus, in effect, Congress was forced to take action. In the Revenue Act of 1948, Congress adopted the "split income" solution to the family income problem. The provision which makes this effective in the income tax is now found in secs. 2(a) and 6013(a) of the 1954 Code. These should be carefully examined. Husbands and wives may now at their election file a joint return, on which the tax is computed as twice the tax on half the income. Thus the tax benefits of the community property system are extended to married persons in the entire country, and the unfair discrimination which long existed in favor of community property states has been ended.[1]

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[1] Under sec. 6013(b) of the 1954 Code, married taxpayers may, subject to certain conditions, file a joint return, even though they have previously filed separate returns for the taxable year. The election to file a joint return may, in most cases, be made as late as 3 years after the due date for filing the return for such year.

Note that this provision does not allow any election to file separate returns after the due date if a joint return has been previously filed. Is there any reason for this differentiation in treatment?

The effect of this change is clearly to diminish the importance of such cases as *Lucas v. Earl,* and subsequent cases in the casebook such as *Helvering v. Clifford* and *Commissioner v. Tower,* so far as husband and wife are concerned. The splitting of income which they made difficult or impossible is now made automatic for all taxpayers by law. This is a major improvement in the tax law, and should greatly reduce controversy and litigation in its administration.

The new law, however, has no application except between husband and wife. It does not affect transfers to children, other relatives, or strangers. The old cases on assignments remain fully applicable to them.

The background of the 1948 act may be found in Surrey, "Family Income and Federal Taxation," 24 Taxes 980 (1946). A detailed discussion of the new provisions is included in the May, 1948, issue of Taxes, and in Surrey, "Federal Taxation of the Family—The Revenue Act of 1948," 61 Harv.L.Rev. 1097 (1948). See also "Joint Income Tax Returns under the Revenue Act of 1948," 36 Calif.L.Rev. 289 (1948); Bock, "Should We Change Our Method of Taxing the Family?" 94 J. of Accountancy 425 (1952); Pedrick, "Familial Obligations and Federal Taxation: A Modest Suggestion," 51 Northwestern U.L.Rev. 53 (1956).

A new provision in the 1954 Code allows the filing of a joint return, with the benefit of the split income provision, by a widow or widower for the two years following the death of the spouse, if the survivor maintains a home with a dependent. Sec. 2 of the 1954 Code.

Head of a Household

The 1951 Act added a new provision establishing a special rate of tax for persons who qualify as the "head of a household." This is now found in sec. 1(b) of the 1954 Code. The objective is to give a head of a household (a person who is not married but who maintains dependents in his home, or maintains his dependent parents in their home) some of the benefit which is available to husbands and wives under the so-called split income provisions of the Code.

Income of Children

At common law, and in many states today, income earned by a minor child is technically the property of the parent. In 1944, the tax law was changed to provide that a child's income is taxable to the child, although the parent was made responsible to see that the tax was paid. This provision is now found in **sec. 73** of the 1954 Code. See also sec. 6201(c), for the continuing liability of the parent to see that the tax is paid.

The Regulations under sec. 73 have been issued as sec. 1.73–1 of the Income Tax Regulations.

Until 1954, a person ceased to be a dependent (for which the taxpayer is entitled to a $600 exemption) if his income was $600 or more. Under sec. 151(e) of the 1954 Code, a child may still be a dependent even though his income is $600 or more if he is (a) under 19, or (b) a student. Note, however, that the dependency status is lost in all cases (subject to the special provision in sec. 152(c) unless the taxpayer contributes more than half of the support. See sec. 152(d) for the rule with respect to the effect of scholarships in determining whether more than half of the support has been contributed.

NATIONAL CARBIDE CORP. v. COMMISSIONER

Supreme Court of the United States, 1949. 336 U.S. 422.

MR. CHIEF JUSTICE VINSON delivered the opinion of the Court.

Petitioners are three wholly owned subsidiaries of Air Reduction Corporation (Airco). They seek a determination of the question whether deficiencies in income and declared value excess profits taxes for the year 1938 found by the Commissioner of Internal Revenue are properly chargeable to them. Their contention is that they are corporate agents of Airco, that the income from their operations is income of Airco, and that income and excess profits taxes must be determined on that basis.

By a series of combinations and dissolutions of previously acquired subsidiary companies, Airco, had, prior to 1938, reduced the number of its subsidiaries to four. All operated strictly in accordance with contracts with Airco.[1] The subsidiaries were

[1] The substance of a typical subsidiary-parent contract is as follows: "Airco hereby employs Sales as its agent to manage and operate, during the term of this contract, all plants for the production of oxygen, acetylene and other gases and for the manufacture of apparatus and containers for the utilization and transportation of such gases . . . ; and likewise employs Sales as its agent to market and sell, during the term of this contract, the output of all such plants. . . . Airco agrees (1) to give Sales the use of all cylinders, containers, motor trucks, equipment, and shipping facilities, which it now owns or may hereafter acquire; (2) to supply such working capital as Sales may need; (3) to provide such executive management (but not accounting, bookkeeping and clerical service), and office accommodation and facilities as may be necessary for the proper conduct of Sales business. . . . Sales agrees (1) to manage and operate. . . . all of said plants; (2) to maintain the same in first class condition, charging necessary repairs and replacements to operating expense and setting aside and charging to operating expense proper reserves for depreciation . . . (3) to distribute, market and sell, the product manufactured in said plants as efficiently as possible . . . (4) to pay all expenses of such operation, maintenance and selling, and to discharge all expenses and liabilities incurred therein or thereby and to collect all accounts receivable

utilized by Airco as operating companies in the four major fields of operation in which it was engaged. Air Reduction Sales Company carried on the manufacture and sale of the gaseous constituents of air; National Carbide Corporation, the manufacture and sale of calcium carbide; Pure Carbonic, Inc., the manufacture and sale of carbon dioxide; and Wilson Welder & Metals Co., the manufacture and sale of welding machines, equipment and supplies.[2]

The contracts between Airco and its subsidiaries provided, in substance, that the latter were employed as agents to manage and operate plants designed for the production of the products assigned to each, and as agents to sell the output of the plants. Airco was to furnish working capital, executive management and office facilities for its subsidiaries. They in turn agreed to pay Airco all profits in excess of six percent on their outstanding capital stock, which in each case was nominal in amount.[3] Title to the assets utilized by the subsidiaries was held by them, and amounts advanced by Airco for the purchase of assets and working capital were shown on the books of the subsidiaries as accounts payable to Airco. The value of the assets of each company thus approximated the amount owed to Airco. No interest ran on these accounts.

Airco and its subsidiaries were organized horizontally into six overriding divisions: corporate, operations, sales, financial, distribution, and research. Officers heading each division were, in turn, officers of the subsidiaries. Top officials of Airco held similar positions in the subsidiary companies. Directors of the subsidiaries met only to ratify the actions of the directors and officers of Airco.

Airco considered the profits turned over to it by the subsidiaries pursuant to the contracts as its own income and reported it as such. Petitioners reported as income only the six percent return on capital that each was entitled to retain. Similarly, in declaring the value of their capital stock for declared value excess profits tax purposes, the subsidiaries reported only the nominal amounts at which the stock was carried on the books of each. The Commissioner notified petitioners of substantial income and

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or other proceeds resulting therefrom; (5) to credit monthly on its books to Airco all profits accruing to it from the operation of its entire business over and above an amount equal to six per cent. (6%) per annum on its outstanding capital stock, which said amount it is hereby authorized to deduct and retain, and it hereby agrees to accept as full compensation for its services hereunder; and (6) to pay over to Airco upon demand any profits becoming due and credited to Airco as aforesaid."

[2] Wilson Welder had a net deficit during the year here involved and is not a petitioner in this action.

[3] Sales had outstanding 125 shares of stock of $100 par value; Carbide's outstanding capital stock was 50 shares of $100 par value; Carbonic also had 50 shares of $100 par value.

excess profits tax deficiencies in their 1938 returns, having taken the position that they are taxable on the income turned over to Airco as well as the nominal amounts retained. The Tax Court held, however, that the income from petitioners' operations in excess of six per cent of their capital stock was income and property of Airco. Three judges dissented. The Court of Appeals for the Second Circuit reversed. 167 F.2d 304. We granted the petition for a writ of certiorari, 335 U.S. 810, because of this conflict of opinion and the disagreement between courts as to the continuing vitality of *Southern Pacific Co. v. Lowe,* 247 U.S. 330 (1918).

Petitioners' contention is, in substance, that our decision in *Moline Properties, Inc. v. Commissioner,* 319 U.S. 436 (1943), which held that the tax laws require taxation of the corporate entity if it engages in "business activity," expressly excepted the situation in which the corporation is the agent of its owner; that *Southern Pacific Co. v. Lowe, supra,* defines the content of "agency" for tax purposes; and that, as the Tax Court found, this Court's characterization of the relationship between the corporations in the *Southern Pacific* case is "aptly descriptive" of the relationship between Airco and petitioners. It must follow, according to petitioners, that income received by them and transmitted to Airco is taxable only to Airco.

Respondent does not quarrel with the first and third propositions. The collision occurs at the second. The issue as presented by petitioners, is, therefore, whether the principal-agent relationship described in the *Southern Pacific* case—and the similar arrangement between Airco and petitioners—contains the "usual incidents of an agency relationship," as that phrase was used in *Moline Properties, Inc. v. Commissioner, supra.*

Petitioners' contention that the *Southern Pacific* case established a concept of agency that has survived our later decisions may be dealt with rather summarily. That case treated income earned by a wholly owned subsidiary before March 1, 1913, the effective date of the Income Tax Act of 1913, as having accrued to its parent prior to that date despite the fact that the actual transfer of funds by declaration of dividends occurred subsequent thereto. The theory of the case was that the two corporations could be treated as identical, for the purposes of the 1913 Act, because of the complete domination and control exercised by the parent over its subsidiary.

By this decision, this Court is said to have "looked beyond the corporate form," [4] and "ignored the separate entity of a corporation."[5] Whatever the dialectics employed, courts and commen-

[4] Mertens, Law of Federal Income Taxation (1948 ed.), Vol. 10A, p. 237.

[5] Finkelstein, The Corporate Entity and the Income Tax, 44 Yale L.J. 436, 448.

tators have agreed that parent and subsidiary were treated as one corporation for the purposes of the taxes there in question; transfer of earnings to the parent was merely "a paper transaction." The *Southern Pacific* case did not, and did not purport to rest on any principle of agency. The only reference to the subsidiary (Central Pacific) as an agent is made in this context:

> ". . . the Central Pacific and the Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former, as stockholder and in other capacities. While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control." 247 U.S. at 337.

It is thus clear beyond doubt that the subsidiary was not referred to as an agent of the parent in the usual or technical sense. "Agency" and "practical identity," as those words are used in the *Southern Pacific* case, are unquestionably opposite sides of the same coin.[6] The close relationship between corporations because of complete ownership and control of one by the other was the basis for the result reached, whatever its articulation.

That basis has been repudiated by subsequent decisions of this Court. Whatever the vitality of *Southern Pacific Co. v. Lowe* on its special facts, we have held that a corporation formed or operated for business purposes must share the tax burden despite substantial identity, in practical operation, with its owner. Complete ownership of the corporation, and the control primarily dependent upon such ownership—the important ingredients of the *Southern Pacific* case—are no longer of significance in determining taxability. *Moline Properties, Inc. v. Commissioner, supra; Burnet v. Commonwealth Improvement Co.,* 287 U.S. 415 (1932).[7]

In both of the cases last cited, the agency argument now urged upon us was made and rejected. In both cases, *Southern Pacific*

6 In Ballantine Separate, Entity of Parent and Subsidiary Corporations, 14 Cal.L.Rev. 12, 18, the writer discusses this use of the agency concept as follows: "What is meant by such terms as 'adjunct,' 'agency,' 'instrumentality,' 'creature' or 'mouthpiece'? What conditions must exist to warrant a court in treating the A corporation as the mere adjunct of the B corporation? The word 'agency' is often used as a synonym of 'adjunct,' whatever that may mean, and as descriptive of a relation variously defined in the cases as 'alter ego,' 'alias,' 'device,' 'dummy,' 'branch,' 'tool,' 'corporate double,' 'business conduit,' 'instrumentality,' etc., but all in the sense of 'means' through which a corporation's own business is actively prosecuted."

7 The case other than Southern Pacific relied upon by the Tax Court was Munson Steamship Co. v. Commissioner, 77 F.2d 849. That case was explained in Moline Properties, Inc. v. Commissioner, supra, as depending upon a particular legislative purpose which justified disregarding the separate entity.

Co. v. Lowe, supra, was relied upon by the taxpayers. In both, we found that the contention that the corporation was the agent of its owner was simply the argument that the subsidiary had no corporate identity distinct from its stockholders in a different form. It is true that petitioners here do not ask that they be ignored completely for tax purposes. They are willing to pay taxes on the nominal amounts they retain as Airco's "agents." But this fact serves to emphasize the inapplicability of the *Southern Pacific* case, upon which they rely. There, as in *Commonwealth Improvement Co.* and *Moline Properties* cases, the decision turned upon the question whether the corporate entity was or was not to be completely ignored for tax purposes. If the Central Pacific had been accorded any tax status in the *Southern Pacific* case, it unquestionably would have been taxed on the entire income it received. In fact, it was so taxed upon all income received after March 1, 1913; only income received prior thereto was considered income of the parent directly.[8]

We think, therefore, that petitioners' argument is without merit because based on an erroneous interpretation of *Southern Pacific Co. v. Lowe, supra.* The agency argument, to quote the opinion in *Moline Properties,* "is basically the same argument of identity in a different form . . . the question of agency or not depends upon the same legal issues as does the question of identity previously discussed." [9] Ownership of a corporation and the control incident thereto can have no different tax consequences when clothed in the garb of agency than when worn as a removable corporate veil.

But it is necessary to go farther. The Tax Court did not, as petitioners seem to think, consider the argument that they were agents of Airco as different from or having any greater validity than the argument of identity of Airco and its subsidiaries. The court, in characterizing petitioners as Airco's agents, used that term exactly as it had been used in the *Southern Pacific, Commonwealth Improvement Co.,* and *Moline Properties* cases. According to the Tax Court's opinion:

> "The issue which [was decided] in this proceeding is: Whether, as the respondent has determined, the income from the operations of the three petitioners belonged not to Airco, the parent but to the petitioners and was taxable to them; or whether, as the three petitioners contend, the income from the operations of the petitioners in 1938, exclusive of the small amounts paid to petitioners under the contracts, be-

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[8] Plaintiff's Exhibit P, No. 452, October Term 1917, is an income tax statement of the subsidiary, Central Pacific Co., showing payment of income taxes on $3,333,846.18, its total net income for 1913 less one-sixth (*i. e.,* making an allowance for the two months before the income tax law went into effect March 1).

[9] 319 U.S. at 440–441.

longed and was taxable to Airco, the parent company, both because the petitioners were in fact incorporated departments, divisions or branches of Airco's business and because the petitioners operated pursuant to express contract with Airco."

The theory upon which the Tax Court expunged the deficiencies apparently was that since the *Southern Pacific Co.* case was not expressly overruled by *Moline Properties*, the "business purpose" rule laid down in the latter is not absolute, but that the corporate entity may be disregarded (or the corporation treated as an agent of its owner) for tax purposes when the facts of ownership and control of the corporation approximate those presented by the *Southern Pacific* case. The Court of Appeals disagreed. It held that under our decisions, when a corporation carries on business activity the fact that the owner retains direction of its affairs down to the minutest detail, provides all of its assets and takes all of its profits can make no difference tax-wise. The court concluded that "Even though *Southern Pacific Co. v. Lowe, supra,* set up a different test, we regard it as *pro tanto* no longer controlling."

The result reached by the Court of Appeals is clearly required by our later decisions. Our reluctance to erase *Southern Pacific* from the books has been due not to any belief that it lays down a correct rule for tax purposes generally, but to the fact that it concerns "very peculiar facts" which make it clearly distinguishable from later cases involving the tax status of a subsidiary or other wholly owned corporation. For that reason, we have, instead, held that it lays down no rule for tax purposes. *Burnet v. Commonwealth Improvement Co., supra,* at p. 419; *Moline Properties, Inc. v. Commissioner, supra,* at p. 439. That the concept of identity of the corporation with its owner set out in the *Southern Pacific* case is incompatible with later decisions of this Court may be demonstrated by a consideration of the facts enumerated and relied upon by the Tax Court, which based such reliance on the emphasis placed upon similar facts in the *Southern Pacific* case. These facts relate to the ownership, control, and right to income reserved by the parent.

So far as control is concerned, we can see no difference in principle between Airco's control of petitioners and that exercised over Moline Properties, Inc., by its sole stockholder. Undoubtedly the great majority of corporations owned by sole stockholders are "dummies" in the sense that their policies and day-to-day activities are determined not as decisions of the corporation but by their owners acting individually. We can see no significance, therefore, in findings of fact such as, "The Airco board held regular meetings and exercised complete control over Airco and each of the petitioners," and "The chairman, vice chairman and presi-

dent of Airco were in charge of the administration and management of the activities of each petitioner and carried out the policies and directives with respect to each petitioner as promulgated by the Airco board." We reversed the Board of Tax Appeals in *Moline Properties* in the face of its finding that "Full beneficial ownership was in Thompson [the sole stockholder], who continued to manage and regard the property as his own individually." [12]

Some stress was placed by the Tax Court, and by petitioners in argument here, upon the form of ownership of assets adopted by Airco and its subsidiaries. Petitioners' capital stock was, as has been stated, nominal in amount. Assets of considerable value, to which title was held by the subsidiaries, were balanced by accounts payable to Airco on the books of each. The Tax Court thought it material that "All assets held by petitioner were furnished to it by Airco, which paid for them with its own cash or stock. Airco supplied all the working capital of each petitioner."

If Airco had supplied assets to its subsidiaries in return for stock valued at amounts equal to the value of the assets, no question could be raised as to the reality of ownership of the assets by the subsidiaries. Airco would then have been in a position comparable, so far as ownership of the assets of petitioners is concerned, to that of the sole stockholder in *Moline Properties.* We think that it can make no difference that financing of the subsidiaries was carried out by means of book indebtedness in lieu of increased book value of the subsidiaries' stock. A corporation must derive its funds from three sources: capital contributions, loans, and profits from operations. The fact that Airco, the sole stockholder, preferred to supply funds to its subsidiaries primarily by the second method, rather than either of the other two, does not make the income earned by their utilization income to Airco. We need not decide whether the funds supplied to petitioners by Airco were capital contributions rather than loans. It is sufficient to say that the very factors which, as petitioners contend, show that Airco "supplied" and "furnished" their assets also indicate that petitioners were the recipients of capital contributions rather than loans.

Nor do the contracts between Airco and petitioners by which the latter agreed to pay all profits above a nominal return to the former, on that account, become "agency" contracts within the meaning of our decisions. The Tax Court felt that the fact that Airco was entitled to the profits by contract shows that the income "belonged to Airco" and should not, for that reason, be taxed to petitioners. Our decisions requiring that income be taxed to those who earn it, despite anticipatory agreements designed

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[12] 45 B.T.A. 647, 650.

to prevent vesting of the income in the earners, foreclose this result. *Lucas v. Earl,* 281 U.S. 111 (1930); *Helvering v. Clifford,* 309 U.S. 331 (1940); *United States v. Joliet & Chicago R. Co.,* 315 U.S. 44 (1942); *Commissioner v. Sunnen,* 333 U.S. 591 (1948). Of course one of the duties of a collection agent is to transmit the money he receives to his principal according to their agreement. But the fact that petitioners were required by contract to turn over the money received by them to Airco, after deducting expenses and nominal profits, is no sure indication that they were mere collection agents. Such an agreement is entirely consistent with the corporation-sole stockholder relationship whether or not any agency exists, and with other relationships as well.

What we have said does not foreclose a true corporate agent or trustee from handling the property and income of its owner-principal without being taxable therefor. Whether the corporation operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent. Absence of the factors mentioned above, and the essentiality of ownership of the corporation to the existence of any "agency" relationship in the *Moline Properties, Commonwealth Improvement Co.,* and *Southern Pacific* cases indicates the fallacy of the agency argument made in those cases.

The same fallacy is apparent in the contention that petitioners are agents of Airco. They claim that they should be taxable on net income aggregating only $1,350, despite the fact that during the tax year (1938) they owned assets worth nearly 20 million dollars, had net sales of approximately 22 million dollars, and earned nearly four and one-half million dollars net. Their employees number in the thousands. We have passed the question whether Airco's interest in these assets is that of owner of the subsidiaries or lender, but whatever the answer, they do not belong to Airco as principal. The entire earnings of petitioners, except for trifling amounts, are turned over to Airco not because the latter could command this income if petitioners were owned by third persons, but because it owns, and thus completely dominates the subsidiaries. Airco, for sufficient reasons of its own, wished to avoid the burdens of principalship. See *Moline Properties, Inc. v. Commissioner, supra; Sheldon Building Corp. v. Commissioner,* 118 F.2d 835 (1941). Compare *Forshay v. Commissioner,* 20 B.T.A. 537 (1930). It cannot now escape the tax

consequences of that choice, no matter how bona fide its motives or longstanding its arrangements. When we referred to the "usual incidents of the agency relation" in the *Moline Properties* case, we meant just that—not the identity of ownership and control disclosed by the facts of this case.

We have considered the other arguments made by petitioners and find them to be without merit. The judgment of the Court of Appeals is

Affirmed.

Notes

Does the Court deal adequately with the "agency" argument? After this case, is it possible for a subsidiary to be in fact the agent of its parent? If not, is that a desirable or a justifiable result? What difference does it make anyhow? Since the corporate rates are not graduated (except for relatively low incomes), what is the difference in result between taxing all of the income to the parent, and dividing it up among the several subsidiaries?

On the general problem, see Stickells, "Corporate Entity and Taxation," 29 B.U.L.Rev. 486 (1949); Cleary, "The Corporate Entity in Tax Cases," 1 Tax L.Rev. 3 (1945); Case, "Disregard of the Corporate Entity in Federal Taxation—The Modern Approach," 30 Va.L.Rev. 398 (1944). See also, Murphy, "Corporate Divisions vs. Subsidiaries," 34 Harv.Bus.Rev., No. 6, p. 83 (1956).

UNITED STATES v. CUMBERLAND PUBLIC SERVICE CO.

Supreme Court of the United States, 1950. 338 U.S. 451.

MR. JUSTICE BLACK delivered the opinion of the Court.

A corporation selling its physical properties is taxed on capital gains resulting from the sale.[1] There is no corporate tax, however, on distribution of assets in kind to shareholders as part of a genuine liquidation.[2] The respondent corporation transferred property to its shareholders as a liquidating dividend in kind. The shareholders transferred it to a purchaser. The question is whether, despite contrary findings by the Court of Claims, this record requires a holding that the transaction was in fact a sale by the corporation subjecting the corporation to a capital gains tax.

Details of the transaction are as follows. The respondent, a closely held corporation, was long engaged in the business of

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1 26 U.S.C. § 22(a); Treas.Reg. 103, § 19.22(a)–19.

2 ". . . No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition. . . ." Treas.Reg. 103, § 19.22(a)–21.

generating and distributing electric power in three Kentucky counties. In 1936 a local cooperative began to distribute Tennessee Valley Authority power in the area served by respondent. It soon became obvious that respondent's Diesel-generated power could not compete with TVA power, which respondent had been unable to obtain. Respondent's shareholders, realizing that the corporation must get out of the power business unless it obtained TVA power, accordingly offered to sell all the corporate stock to the cooperative, which was receiving such power. The cooperative refused to buy the stock, but countered with an offer to buy from the corporation its transmission and distribution equipment. The corporation rejected the offer because it would have been compelled to pay a heavy capital gains tax. At the same time the shareholders, desiring to save payment of the corporate capital gains tax, offered to acquire the transmission and distribution equipment and then sell to the cooperative. The cooperative accepted. The corporation transferred the transmission and distribution systems to its shareholders in partial liquidation. The remaining assets were sold and the corporation dissolved. The shareholders then executed the previously contemplated sale to the cooperative.

Upon this sale by the shareholders, the Commissioner assessed and collected a $17,000 tax from the corporation on the theory that the shareholders had been used as a mere conduit for effectuating what was really a corporate sale. Respondent corporation brought this action to recover the amount of the tax. The Court of Claims found that the method by which the stockholders disposed of the properties was avowedly chosen in order to reduce taxes, but that the liquidation and dissolution genuinely ended the corporation's activities and existence. The court also found that at no time did the corporation plan to make the sale itself. Accordingly it found as a fact that the sale was made by the shareholders, rather than the corporation, and entered judgment for respondent. One judge dissented, believing that our opinion in *Commissioner v. Court Holding Co.*, 324 U.S. 331, required a finding that the sale had been made by the corporation. Certiorari was granted to clear up doubts arising out of the *Court Holding Co.* case.

Our *Court Holding Co.* decision rested on findings of fact by the Tax Court that a sale had been made and gains realized by the taxpayer corporation. There the corporation had negotiated for sale of its assets and had reached an oral agreement of sale. When the tax consequences of the corporate sale were belatedly recognized, the corporation purported to "call off" the sale at the last minute and distributed the physical properties in kind to the stockholders. They promptly conveyed these properties to the same persons who had negotiated with the corporation. The

terms of purchase were substantially those of the previous oral agreement. One thousand dollars already paid to the corporation was applied as part payment of the purchase price. The Tax Court found that the corporation never really abandoned its sales negotiations, that it never did dissolve, and that the sole purpose of the so-called liquidation was to disguise a corporate sale through use of mere formalisms in order to avoid tax liability. The Circuit Court of Appeals took a different view of the evidence. In this Court the Government contended that whether a liquidation distribution was genuine or merely a sham was traditionally a question of fact. We agreed with this contention, and reinstated the Tax Court's findings and judgment. Discussing the evidence which supported the findings of fact, we went on to say that "the incidence of taxation depends upon the substance of a transaction" regardless of "mere formalisms" and that taxes on a corporate sale cannot be avoided by using the shareholders as a "conduit through which to pass title."

This language does not mean that a corporation can be taxed even when the sale has been made by its stockholders following a genuine liquidation and dissolution.[3] While the distinction between sales by a corporation as compared with distribution in kind followed by shareholder sales may be particularly shadowy and artificial when the corporation is closely held, Congress has chosen to recognize such a distinction for tax purposes. The corporate tax is thus aimed primarily at the profits of a going concern. This is true despite the fact that gains realized from corporate sales are taxed, perhaps to prevent tax evasions, even where the cash proceeds are at once distributed in liquidation.[4] But Congress has imposed no tax on liquidating distributions in kind or on dissolution, whatever may be the motive for such liquidation. Consequently, a corporation may liquidate or dissolve without subjecting itself to the corporate gains tax, even though a primary motive is to avoid the burden of corporate taxation.

Here, on the basis of adequate subsidiary findings, the Court of Claims has found that the sale in question was made by the stockholders rather than the corporation. The Government's

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[3] What we said in the Court Holding Co. case was an approval of the action of the Tax Court in looking beyond the papers executed by the corporation and shareholders in order to determine whether the sale there had actually been made by the corporation. We were but emphasizing the established principle that in resolving such questions as who made a sale, fact finding tribunals in tax cases can consider motives, intent, and conduct in addition to what appears in written instruments used by parties to control rights as among themselves. See e. g., Helvering v. Clifford, 309 U.S. 331, 335–337; Commissioner v. Tower, 327 U.S. 280.

[4] It has also been held that where corporate liquidations are effected through trustees or agents, gains from sales are taxable to the corporation as though it were a going concern. See, e. g., First Nat'l Bank of Greeley, Colorado v. United States, 86 F.2d 938, 941; Treas.Reg. 103, § 19.22(a)–21.

argument that the shareholders acted as a mere "conduit" for a sale by respondent corporation must fall before this finding. The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.

The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern. For a corporation is taxed if it sells all its physical properties and distributes the cash proceeds as liquidating dividends, yet is not taxed if that property is distributed in kind and is then sold by the shareholders. In both instances the interest of the shareholders in the business has been transferred to the purchaser. Again, if these stockholders had succeeded in their original effort to sell all their stock, their interest would have been transferred to the purchasers just as effectively. Yet on such a transaction the corporation would have realized no taxable gain.

Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate. It is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs. Here as in the *Court Holding Co.* case we accept the ultimate findings of fact of the trial tribunal. Accordingly the judgment of the Court of Claims is

Affirmed.

Notes

(A) This problem is now largely covered by **sec. 337** of the 1954 Code. However the question still remains where the transaction does not come within the statutory provision—as where the liquidation is not completed within twelve months, or where the property involved is inventory property. It is important, therefore, to keep the situation in mind; and in many cases it may be possible to avoid any possible question by having a liquidation before there are any negotiations for sale.

The Regulations under sec. 337 have been issued as secs. 1.337–1 through 1.337–5 of the Income Tax Regulations.

Why cannot the whole question be avoided by selling the stock of the corporation, with the purchaser of the stock carrying out a liquidation after the stock is acquired? What questions might arise in connection with such a transfer? Is there any reason why the purchaser might not want to buy the stock of the corporation?

(B) For discussions under the 1954 Code, see MacLean, "Taxation of Sales of Corporate Assets in the Course of Liquidation," 56 Col.L.Rev. 641 (1956); Prisamt, "Disposal of Appreciated Corporate Assets Together with the Corporate Shell," 34 Taxes 619 (1956); Roberts, "Statutory Solution to the Court Holding Company Enigma," 34 Taxes 431 (1956).

A Note in 10 Syracuse L.Rev. 103 (1958) contains a discussion of sec. 377(d), which was added in 1958, as well as of other aspects of sec. 377.

(C) Suppose a corporation sells an asset, and then within a year distributes all its remaining assets to its shareholders pursuant to a plan of liquidation. However, it does not formally wind up its affairs; and it is immediately reactivated (in a different business) by transfer of new assets to it. The Treasury has ruled that this is not a complete liquidation within sec. 337, and that the non-recognition provisions of that section are not applicable. Rev.Rul. 60–50, 1960–1 Cum.Bull. ——.

(D) A corporation sells its assets at a profit and then liquidates within a year, in order to take advantage of sec. 337. Although no gain is recognized on the sale of its assets for Federal tax purposes, because of sec. 337, there is no corresponding provision in the state tax law, and it paid a state tax on the gain of $71,000. It sought to deduct this tax on its final income tax return. This was disallowed on the ground that the gain was "exempt income" within the meaning of sec. 265, with the result that the otherwise allowable deduction allocable to it was not deductible. *Hawaiian Trust Co., Ltd. v. United States,* 178 F. Supp. 637 (D. Hawaii 1959). See also "Watch Your Step on the Way Out—Tax Savings on Sale of Corporate Assets under Sec. 337, 1954 Int.Rev.Code," 24 Mo.L.Rev. 342 (1959).

(E) Suppose that property is destroyed by fire during the year of liquidation, and there is an insurance recovery. If there is a gain is it protected from tax by sec. 337? An affirmative answer was given in *Towanda Textiles Inc. v. United States,* 180 F.Supp. 373 (Ct.Cls.1960). But two weeks later, the Tax Court decided to the contrary. *Kent Manufacturing Co.,* 33 T.C. 930 (1960).

B. TRUST INCOME

For general discussion, under the 1954 Code, see Kamin, Surrey, and Warren, "The Internal Revenue Code of 1954: Trusts, Estates, and Beneficiaries," 54 Col.L.Rev. 1237 (1954); Casner, "Estate Planning," 68 Harv.L.Rev. 222 (1954); Craven, "Taxation of Estate and Trust Income under the 1954 Code," 103 U. of Pa.L.Rev. 602 (1955); Fillman, "Selections from Subchapter J," 10 Tax L.Rev. 453 (1955).

Income Taxable to the Grantor

Secs. 671–678 of the 1954 Code

Secs. 1.671–1 through 1.678(d)–1 of the Income Tax Regulations

CORLISS v. BOWERS

Supreme Court of the United States, 1930. 281 U.S. 376.

MR. JUSTICE HOLMES delivered the opinion of the Court.

This is a suit to recover the amount of an income tax paid by the plaintiff, the petitioner, under the Revenue Act of 1924, June 2, 1924, c. 234, sec. 219(g), (h), 43 Stat. 253, 277 (U.S.C., Tit. 26, sec. 960.) The complaint was dismissed by the District Court, 30 F.2d 135, and the judgment was affirmed by the Circuit Court of Appeals, 34 F.2d 656. A writ of certiorari was granted by this Court.

The question raised by the petitioner is whether the above section of the Revenue Act can be applied constitutionally to him upon the following facts. In 1922 he transferred the fund from which arose the income in respect of which the petitioner was taxed, to trustees, in trust to pay the income to his wife for life with remainder over to their children. By the instrument creating the trust the petitioner reserved power "to modify or alter in any manner, or revoke in whole or in part, this indenture and the trusts then existing, and the estates and interests in property hereby created" &c. It is not necessary to quote more words because there can be no doubt that the petitioner fully reserved the power at any moment to abolish or change the trust at his will. The statute referred to provides that "when the grantor of a trust has, at any time during the taxable year, . . . the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." Section 219(g) with other similar provisions as to income in section 219(h). There can be no doubt either that the statute purports to tax the plaintiff in this case. But the net income for 1924 was paid over to the petitioner's wife and the petitioner's argument is that however it might have been in different circumstances the income never was his and he cannot be taxed for it. The legal estate was in the trustee and the equitable interest in the wife.

But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed— the actual benefit for which the tax is paid. If a man directed

his bank to pay over income as received to a servant or friend, until further orders, no one would doubt that he could be taxed upon the amounts so paid. It is answered that in that case he would have a title, whereas here he did not. But from the point of view of taxation there would be no difference. The title would merely mean a right to stop the payment before it took place. The same right existed here although it is not called a title but is called a power. The acquisition by the wife of the income became complete only when the plaintiff failed to exercise the power that he reserved. *Saltonstall v. Saltonstall,* 276 U.S. 260, 271. *Chase National Bank v. United States,* 278 U.S. 327. *Reinecke v. Northern Trust Co.,* 278 U.S. 339. Still speaking with reference to taxation, if a man disposes of a fund in such a way that another is allowed to enjoy the income which it is in the power of the first to appropriate it does not matter whether the permission is given by assent or by failure to express dissent. The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not. We consider the case too clear to need help from the local law of New York or from arguments based on the power of Congress to prevent escape from taxes or surtaxes by devices that easily might be applied to that end.

Judgment affirmed.

The CHIEF JUSTICE took no part in this case.

Notes

(A) The settlor was one of three trustees, and reserved the power to revoke with the consent of either of the other trustees, one of whom was a beneficiary, and the other a trust company. In *Reinecke v. Smith,* 289 U.S. 172 (1933), the Court held that a trustee as such did not have "a substantial adverse interest," and that the statute as so construed was constitutional. Are there any reasons for the differences between the provisions as to trusts in the income tax and in the estate tax (sec. 2038 of the 1954 Code)?

(B) Until 1934, the provision now found in sec. 676 of the 1954 Code, read: "Where at any time *during the taxable year* the power to revest," etc. Under this form of the statute, it was held in some cases that the settlor was not taxable on the income of a trust where he could revoke it only if he had given notice a year and a day in advance, or in the preceding taxable year. See G.C.M. 11640, XII–1 C.B. 144 (1933). In the Revenue Act of 1934, Congress struck out the italicized words. See House Report No. 1385, 73d Cong., 2d Session, p. 24 (Amendments Nos. 96 and 97). Is there any doubt about the effect or validity of this change? See *Kraft v. Commissioner,* 111 F.2d 370 (C.C.A. 3d, 1940), cert. den. 311 U.S. 671 (1940), upholding the new law as applied to income received in 1934 before the statute was changed.

FULHAM v. COMMISSIONER

United States Circuit Court of Appeals, First Circuit, 1940. 110 F.2d 916.

MAGRUDER, J. Petitioner was the grantor of a trust. The Commissioner of Internal Revenue concluded that the income of the trust was taxable to the grantor, under Section 166 of the Revenue Act of 1934 (48 Stat. 729), and determined a deficiency in petitioner's income tax for 1935 in the sum of $1184.89. We have before us a petition to review a decision of the Board of Tax Appeals upholding the Commissioner.

The trust was created in 1930. Petitioner conveyed certain property to himself and another as co-trustee. Clause First provided:

> "Until the death of my wife, Mary E. Fulham, the trustees shall accumulate the income of the trust fund. During my wife's life the trustees may pay to her at any time or from time to time any part or parts or the whole of the principal and/or accumulated income of the trust fund."

Clauses Second and Third contained detailed provisions, operative upon the death of Mary E. Fulham, for the payment of income, and eventually the principal, to the children of the grantor and their issue. Clause Fourth gave the trustees broad powers of management "as if they were the absolute owners free of all trust," specifically mentioning among others the power to invest and reinvest "irrespective of rules of law" and the power "to lend money to any person including any trustee or beneficiary with or without security." Clause Fifth set up a committee of three named persons having a joint power, exercisable in writing by any two of the committee, in terms as follows:

> "A. To change, alter, and revoke any of the trusts herein set forth, and declare new trusts of the property in any way or manner, and to change, alter, and revoke any or all of the provisions of this instrument. No exercise of this power shall exhaust it. It may, however, be released, extinguished, or restricted by a like instrument so signed by any two of the Committee. Without qualifying or limiting the foregoing power in any particular, it shall include the power to alter the number of, the powers of, and the succession among the trustees, the power to remove trustees, the power to appoint successor trustees, the power to appoint additional trustees, and the power to alter the number of, the power of and the succession among the Committee, and to appoint additional members of the Committee and successor members of the Committee."

At this time revocable trusts were governed by Section 166 of the Revenue Act of 1928 (45 Stat. 840), which provided that the income was taxable to the grantor where the grantor had "at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself" title to the corpus of the trust. Here the grantor reserved to himself no formal power of revocation either alone or in conjunction with the members of the committee. Section 166 was amended in the Revenue Act of 1932 in order to block a possible means of tax avoidance by the device of vesting the power to revoke the trust in some person other than a beneficiary, whereby in fact the grantor may retain "substantially the same control as if he alone had power to revoke the trust." . . .

It is specifically conceded in the brief of the petitioner that the committee, in whom the power to revoke the trust was originally vested, did not have "a substantial adverse interest" in the disposition of the corpus or income therefrom, and we shall consider the case on the basis of that concession. *Cf. Corning v. Commissioner*, 104 F.2d 329, 333. Consequently, if the provisions of the trust instrument had remained unaltered, the income from the entire corpus would have been taxable to the grantor under paragraph 2 of Section 166 of the Revenue Acts of 1932 and 1934.

However, shortly after the enactment of the 1932 amendment the designated committee executed an instrument amending Clause Fifth of the trust indenture by inserting the following at the end of paragraph A thereof:

> "It is further provided, however, that the power created in Paragraph A of Clause Fifth of the trust instrument shall not be exercised while Mary E. Fulham is living and competent to act in any manner so as to revest in the creator John N. Fulham any part or all of the corpus or income of the trust fund, unless the exercise of such power is consented to in writing by said Mary E. Fulham. In so far as the Committee may have any power to alter, amend, or revoke the proviso contained in the last sentence, they hereby relinquish and extinguish such power."

By this amendment the power of the committee to revoke the trust and revest the corpus in the grantor became subject to the written consent of Mary E. Fulham. If Mrs. Fulham is found to be a person "not having a substantial adverse interest" in the disposition of the corpus or income therefrom, then the amendment has failed of its obvious purpose, and the income is taxable to the grantor under Section 166.

We think Mrs. Fulham does not have "a substantial adverse interest" within the meaning of the statute.

The evident policy of the Revenue Act is to tax the income to the grantor of a trust when he retains the substantial mastery over the corpus. Even though in form he lodges the power of revocation in someone other than himself, Section 166 is founded on the reasonable premise that the grantor still retains practical mastery, when this power is given to someone having no stake in the trust, or a stake so insubstantial that the holder of the power would not improbably be amenable to the grantor's wishes. This calls for a realistic appraisal.

On the face of the trust instrument, the main objective seems to be to accumulate the income during the life of Mrs. Fulham for the benefit of the children. True, it is provided that the trustees "may" make payments to Mrs. Fulham. On the strength of this, petitioner argues that "Mrs. Fulham is a beneficiary of the trust, to whom the trustee owes a duty of loyalty, and to whom the trustee is accountable in the event of arbitrary, unreasonable or dishonest action." Perhaps Mrs. Fulham has some interest, of a tenuous sort, cognizable in equity. Thus, a court of equity might, at her instance, enjoin the trustees from wasting the estate, her interest in its preservation being based on the theory that though the present trustees may not be disposed to give her anything, their successors might be. Again, if the trustees had exercised their judgment in favor of Mrs. Fulham and had decided to make a payment to her, they might be guilty of a breach of fiduciary obligation to her if they thereafter accepted a bribe from the remaindermen to withhold the payment. But no criterion is laid down for the guidance of the trustees, as in *Corkery v. Dorsey,* 223 Mass. 97, 111 N.E. 795 (1916), relied on by petitioner, where the trustee was empowered to make payments to a designated beneficiary when in the judgment of the trustee the beneficiary "is deserving and in need of aid" in such sums as the trustee "may deem expedient or necessary" for the best interests of the beneficiary. Neither that case, nor *Dumaine v. Dumaine,* 301 Mass. 214, 16 N.E.2d 625 (1938), nor *Boyden v. Stevens,* 285 Mass. 176 (1934), also cited by petitioner, warrants the conclusion that under the trust instrument here in question Mrs. Fulham might in any circumstances successfully invoke the aid of a court of equity to compel the trustees to exercise their discretion in her favor. It does not appear in the record that Mrs. Fulham has in fact been receiving any payments under Clause First. Furthermore, even if Mrs. Fulham might in necessitous circumstances appeal to a court of equity against the trustees (one of whom, by the way, is her husband, the grantor), for aught that appears in the record this may be so remote a contingency as to furnish no assurance that Mrs. Fulham would be likely to stand out against her husband's wishes in case he desired the corpus of the trust to be revested in

himself. In this connection, the observations of the Supreme Court in *Helvering v. Clifford,* 309 U.S. 331, are pertinent, though made in reference to Section 22(a) of the Revenue Act. See also *Rollins v. Helvering,* 92 F.2d 390, 393–95.

The insubstantial character of Mrs. Fulham's interest in the corpus of the trust is further evident from the fact that the committee could at any time by further amendment of the first instrument destroy her interest, whatever it is, by taking away from the trustees the power to make payments to her. No such feature was present in *Corning v. Commissioner,* 104 F.2d 329. Moreover, that case, whether rightly decided or not, is not a contrary authority, for there the person having the veto power over revesting the corpus in the grantor had a more substantial interest than Mrs. Fulham here, and, according to the court, "in any event would receive the corpus if he survived the petitioner," the grantor.

In the case at bar, it having been concluded that Mrs. Fulham has not a substantial adverse interest, there is no doubt that the power vested in the committee, subject to her veto under Clause Fifth, as amended, is a power to revest title of the corpus in the grantor within the meaning of Section 166. Therefore, our decision in *Higgins v. White,* 93 F.2d 357, is not now relevant, because in that case the power which the trust deed vested in the grantor and his co-trustees to revest the corpus in the grantor if "the trustees shall deem it wise so to do" was held to be a fiduciary power subject to the control of a court of equity, and not an absolute and unconditional power vested in the grantor either alone or in conjunction with the other trustees.

Upon appraisal of the trust instrument against a background of realities, we are convinced that this is a typical arrangement, falling within Section 166, where the grantor retains the controlling hand over something he has seemed to give away. In the view we take, it is unnecessary to consider alternative contentions of the Commissioner under Section 166 and Section 167 of the Revenue Act.

The decision of the Board of Tax Appeals is affirmed.[1]

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[1] *Cf.* Fulham v. Commissioner, 44 B.T.A. 1183 (1941), where it appeared that the trust was amended on December 27, 1935, so as to preclude any part of the corpus, income, or accumulation from revesting in the grantor. It was held that no part of the income for 1936 was taxable to the grantor. The Commissioner acquiesced in this decision. 1941–2 Cum.Bull. 5.

See Brunner, "Substantial Adverse Interests," 21 Taxes 385 (1943).

BURNET v. WELLS

Supreme Court of the United States, 1933. 289 U.S. 670.

MR. JUSTICE CARDOZO delivered the opinion of the Court.

Income of a trust has been reckoned by the taxing officers of the government as income to be attributed to the creator of the trust in so far as it has been applied to the maintenance of insurance on his life. Section 219(h) of the Revenue Acts of 1924 and 1926 permits this to be done. The question is whether as applied to this case the acts are constitutional.

On December 30, 1922, the respondent, Frederick B. Wells, created three trusts, referred to in the record as Nos. 1, 2, and 3, and on August 6, 1923, two additional ones, Nos. 4 and 5, all five being irrevocable.

By trust No. 1, he assigned certain shares of stock of the par value of $100,000 to the Minneapolis Trust Company as trustee. The income of the trust was to be used to pay the annual premiums upon a policy of insurance for $100,000 on the life of the grantor. After the payment of the premiums, the excess income, if any, was to be accumulated until an amount sufficient to pay an additional annual premium had been reserved. Any additional income was, in the discretion of the trustee, to be paid to a daughter. Upon the death of the grantor, the trustee was to collect the policy, and with the proceeds was to buy securities belonging to the Wells estate amounting to $100,000 at their appraised value. The securities so purchased, which were a substitute for the cash proceeds of the policy, were to be held as part of the trust during the life of the daughter, who was to receive the income. On her death the trust was to end, and the corpus was to be divided as she might appoint by her will, and, in default of appointment or issue, to the grantor's sons.

The other trusts carried out very similar plans, though for the use of other beneficiaries. Thus, trust No. 2 had in view the preservation of a policy of life insurance which was to be held when collected for the use of one Lindstrom, said to be a kinswoman. Trust No. 3 was directed to the maintenance of four policies of insurance for named beneficiaries, three of them relatives of the grantor and one a valued employee, who later became his wife. Trust No. 4 kept alive seven policies of life insurance which had been taken out by the grantor for the use of sons and daughter, and three accident policies for his own use. Trust No. 5 kept alive nine life policies for his sons and daughter, and two accident policies for himself. Several of the deeds made provision for contingent limitations for the benefit of charities.

The grantor in making the returns of his own income for the years 1924, 1925, and 1926, did not include any part of the income

belonging to the trusts. Upon an audit of the returns the Commissioner of Internal Revenue assessed a deficiency to the extent that the income of the trusts had been applied to the payment of premiums on the policies of insurance. There was no attempt to charge against the taxpayer the whole income of the trusts, to charge him with the excess applied to other uses than the preservation of the policies. The deficiency assessment was limited to that part of the income which had kept the policies alive. The Board of Tax Appeals upheld the Commissioner. 19 B.T.A. 1213. The Circuit Court of Appeals reversed, except as to the premiums on the policies of accident insurance, those policies, in the event of loss thereunder, being payable to the insured himself. As to the income applied to the maintenance of the policies of life insurance, payable, as they were, to persons other than the insured or his estate, the Court of Appeals held that an assessment could not be made against the creator of the trust without an arbitrary taking of his property in violation of the Fifth Amendment. 63 F.2d 425. Section 219(h) of the Revenue Acts of 1924 and 1926, permitting such an assessment, was adjudged to be void. The court drew no distinction between the validity of the statute in its application to trusts in existence at the time of its enactment and its validity in application to trusts to be created afterwards. A writ of certiorari brings the case here.

The meaning of the statute is not doubtful, whatever may be said of its validity. "Where any part of the income of a trust is or may be applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in paragraph (10) of subdivision (a) of section 214 [the exception having relation to trusts for charities]), such part of the income of the trust shall be included in computing the net income of the grantor." Section 219(h), Revenue Act of 1924, c. 234, 43 Stat. 253, 26 U.S.Code, sec. 960; Revenue Act of 1926, c. 27, 44 Stat. 9, 26 U.S.Code App., sec. 960.

The purpose of the law is disclosed by its legislative history, and indeed is clear upon the surface. When the bill which became the Revenue Act of 1924 was introduced in the House of Representatives, the report of the Committee on Ways and Means made an explanatory statement. Referring to section 219(h) it said: "Trusts have been used to evade taxes by means of provisions allowing the distribution of the income to the grantor or its use for his benefit. The purpose of this subdivision of the bill is to stop this evasion." House Report No. 179, 68th Congress, 1st Session, p. 21. There is a like statement in the report of the Senate Committee on Finance. Senate Report, No. 398, 68th Congress, 1st Session, pp. 25, 26. By the creation of trusts, incomes had been so divided and subdivided as to withdraw from

the government the benefit of the graduated taxes and surtaxes applicable to income when concentrated in a single ownership. Like methods of evasion, or, to speak more accurately, of avoidance (*Bullen v. Wisconsin,* 240 U.S. 625, 630), had been used to diminish the transfer or succession taxes payable at death. One can read in the revisions of the Revenue Acts the record of the government's endeavor to keep pace with the fertility of invention whereby taxpayers had contrived to keep the larger benefits of ownership and be relieved of the attendant burdens.

A method, much in vogue until an amendment made it worthless, was the creation of a trust with a power of revocation. This device was adopted to escape the burdens of the tax upon incomes and the tax upon estates. To neutralize the effect of the device in its application to incomes, Congress made provision by section 219(g) of the Revenue Act of 1924 that, "where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." The validity of this provision was assailed by taxpayers. It was upheld by this court in *Corliss v. Bowers,* 281 U.S. 376, as applied to a trust in existence at the enactment of the statute, the power of revocation in that case being reserved to the grantor alone, and recently, at the present term, was upheld where the power of revocation had been reserved to the grantor in conjunction with some one else. *Reinecke v. Smith,* 289 U.S. 172. *Cf. Burnet v. Guggenheim,* 288 U.S. 280. Other amendments of the statute were directed to the trust as an instrument for the avoidance of the tax upon estates. By section 302(d) of the Revenue Act of 1924, the gross estate of a decedent is to be taken as including the subject of any trust which he has created during life "where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend or revoke, or where the decedent relinquished any such power in contemplation of his death, except in case of bona fide sale for a fair consideration in money or money's worth." The validity of this provision as to trusts both past and future is no longer open to debate. *Porter v. Commissioner,* 288 U.S. 436. *Cf. Reinecke v. Northern Trust Co.,* 278 U.S. 339; *Chase National Bank v. United States,* 278 U.S. 327; *Saltonstall v. Saltonstall,* 276 U.S. 260. Through the devices thus neutralized, as well as through many others, there runs a common thread of purpose. The solidarity of the family is to make it possible for the taxpayer to surrender title to another and to keep dominion for himself,

or, if not technical dominion, at least the substance of enjoyment. At times escape has been blocked by the resources of the judicial process without the aid of legislation. Thus, *Lucas v. Earl,* 281 U. S. 111, held that the salary earned by a husband was taxable to him, though he had bound himself by a valid contract to assign it to his wife. *Burnet v. Leininger,* 285 U.S. 136, laid down a like rule where there had been an assignment by a partner of his interest in the future profits of a partnership. *Old Colony Trust Co. v. Commissioner,* 279 U.S. 716, and *United States v. Boston & Maine Railroad Co.,* 279 U.S. 732, held that income was received by a taxpayer when pursuant to a contract a debt or other obligation was discharged by another for his benefit, the transaction being the same in substance as if the money had been paid to the debtor and then transmitted to the creditor. *Cf. United States v. Mahoning Coal Railroad Co.* (C.C.A.) 51 F.2d 208. In these and other cases there has been a progressive endeavor by the Congress and the courts to bring about a correspondence between the legal concept of ownership and the economic realities of enjoyment or fruition. Of a piece with that endeavor is the statute now assailed.

The controversy is one as to the boundaries of legislative power. It must be dealt with in a large way, as questions of due process always are, not narrowly or pedantically, in slavery to forms or phrases. "Taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss v. Bowers, supra,* page 378. *Cf. Burnet v. Guggenheim, supra,* page 283. Refinements of title have at times supplied the rule when the question has been one of construction and nothing more, a question as to the meaning of a taxing act to be read in favor of the taxpayer. Refinements of title are without controlling force when a statute, unmistakable in meaning, is assailed by a taxpayer as overpassing the bounds of reason, an exercise by the lawmakers of arbitrary power. In such circumstances the question is no longer whether the concept of ownership reflected in the statute is to be squared with the concept embodied, more or less vaguely, in common-law traditions. The question is whether it is one that an enlightened legislator might act upon without affront to justice. Even administrative convenience, the practical necessities of an efficient system of taxation, will have heed and recognition within reasonable limits. *Milliken v. United States,* 283 U.S. 15, 24, 25; *Reinecke v. Smith, supra.* Liability does not have to rest upon the enjoyment by the taxpayer of all the privileges and benefits enjoyed by the most favored owner at a given time or place. *Corliss v. Bowers, supra; Reinecke v. Smith, supra.* Government in casting about for proper subjects of taxation is not confined by the traditional classification of in-

terests or estates. It may tax, not only ownership, but any right or privilege that is a constituent of ownership. *Nashville, Chattanooga & St. Louis Ry. Co. v. Wallace,* 288 U.S. 249, 268; *Bromley v. McCaughn,* 280 U.S. 124, 136. Liability may rest upon the enjoyment by the taxpayer of privileges and benefits so substantial and important as to make it reasonable and just to deal with him as if he were the owner, and to tax him on that basis. A margin must be allowed for the play of legislative judgment. To overcome this statute the taxpayer must show that in attributing to him the ownership of the income of the trusts, or something fairly to be dealt with as equivalent to ownership, the lawmakers have done a wholly arbitrary thing, have found equivalence where there was none nor anything approaching it, and laid a burden unrelated to privilege or benefit. *Purity Extract & Tonic Co. v. Lynch,* 226 U.S. 192, 204; *Hebe Co. v. Shaw,* 248 U.S. 297, 303; *Milliken v. United States, supra.* The statute, as we view it, is not subject to that reproach.[1]

A policy of life insurance is a contract susceptible of ownership like any other chose in action. It "is not an assurance for a single year, with a privilege of renewal from year to year by paying the annual premium." It is "an entire contract of assurance for life, subject to discontinuance and forfeiture for non-payment of any of the stipulated premiums." *N. Y. Life Insurance Co. v. Statham,* 93 U.S. 24, 30; Vance on Insurance, pp. 260, 262, and cases there cited. One who takes out a policy on his own life, after application in his own name accepted by the company, becomes in so doing a party to a contract, though the benefits of the insurance are to accrue to some one else. *Mutual Life Insurance Co. v. Hurni Packing Co.,* 263 U.S. 167, 177; Vance on Insurance, pp. 90, 91, and 108. The rights and interests thereby generated do not inhere solely in those who are to receive the proceeds. They inhere also in the insured who in co-operation with the insurer has brought the contract into being. If the Minneapolis Trust Company, the trustee, were to refuse to apply the income to the preservation of the insurance, the insured might maintain a suit to hold it to its duty. If the insurer without cause were to repudiate the policies, the insured would have such an interest in the preservation of the contracts that he might maintain a suit in equity to declare them still in being. *Cohen v. M. L. Ins. Co.,* 50 N.Y. 610, 624; *Meyer v. Knickerbocker L. Ins. Co.,* 73 N.Y. 516, 524; *Fidelity National Bank v. Swope,* 274 U.S. 123, 132; *cf. Croker v. N. Y. Trust Co.,* 245 N.Y.

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[1] The trusts, having been created in 1922 and 1923, were not subject to the gift tax of 1924, 43 Stat. 253, 313, 314, c. 234, secs. 319, 320, 26 U.S.Code, secs. 1131, 1132. Whether they would have been subject to that tax if they had been created at a later date is a question not before us. There is no inconsistency between a gift to take effect in enjoyment upon the death of a grantor and the reservation of benefits to be enjoyed during his life.

17, 18, 20, 156 N.E. 81; *Johnson Service Co. v. Monin, Inc.*, 253 N.Y. 417, 421, 171 N.E. 692; American Law Institute, Restatement of the Law of Contracts, secs. 135, 138; Williston, Contracts, secs. 358, 359. The contracts remain his, or his at least in part, though the fruits when they are gathered are to go to some one else. American Law Institute, Restatement of the Law of Contracts, *supra.*

With the aid of this analysis the path is cleared to a conclusion. Wells by the creation of these trusts did more than devote his income to the benefit of relatives. He devoted it at the same time to the preservation of his own contracts, to the protection of an interest which he wished to keep alive. The ends to be attained must be viewed in combination. True he would have been at liberty, if the trusts had not been made, to put an end to his interest in the policies through nonpayment of the premiums, to stamp the contracts out. The chance that economic changes might force him to that choice was a motive, along with others, for the foundation of the trusts. In effect he said to the trustee that for the rest of his life he would dedicate a part of his income to the preservation of these contracts, so much did they mean for his peace of mind and happiness. Income permanently applied by the act of the taxpayer to the maintenance of contracts of insurance made in his name for the support of his dependents is income used for his benefit in such a sense and to such a degree that there is nothing arbitrary or tyrannical in taxing it as his.

Insurance for dependents is to-day in the thought of many a pressing social duty. Even if not a duty, it is a common item in the family budget, kept up very often at the cost of painful sacrifice, and abandoned only under dire compulsion. It will be a vain effort at persuasion to argue to the average man that a trust created by a father to pay premiums on life policies for the use of sons and daughters is not a benefit to the one who will have to pay the premiums if the policies are not to lapse. Only by closing our minds to common modes of thought, to everyday realities, shall we find it in our power to form another judgment. The case is not helped by imagining exceptional conditions in which the advantage to the creator of the trust would be slender or remote. By and large the purpose of trusts for the maintenance of policies is to make provision for dependents, or so at least the lawmakers might not unreasonably assume. . . .

Trusts for the preservation of policies of insurance involve a continuing exercise by the settlor of a power to direct the application of the income along predetermined channels. In this they are to be distinguished from trusts where the income of a fund, though payable to wife or kin, may be expended by the beneficiaries without restraint, may be given away or squandered,

the founder of the trust doing nothing to impose his will upon the use. There is no occasion at this time to mark the applicable principle for those and other cases. The relation between the parties, the tendency of the transfer to give relief from obligations that are recognized as binding by normal men and women, will be facts to be considered. *Cf. Reinecke v. Smith, supra,* distinguishing *Hoeper v. Tax Commission,* 284 U.S. 206. We do not go into their bearing now. Here the use to be made of the income of the trust was subject, from first to last, to the will of the grantor announced at the beginning. A particular expense, which for millions of men and women has become a fixed charge, as it doubtless was for Wells, an expense which would have to be continued if he was to preserve a contract right, was to be met in a particular way. He might have created a blanket trust for the payment of all the items of his own and the family budget, classifying the proposed expenses by adequate description. If the transaction had taken such a form, one can hardly doubt the validity of a legislative declaration that income so applied should be deemed to be devoted to his use. Instead of shaping the transaction thus, he picked out of the total budget an item or class of items, the cost of continuing his contracts of insurance, and created a source of income to preserve them against lapse.

Congress does not play the despot in ordaining that trusts for such uses, if created in the future, shall be treated for the purpose of taxation as if the income of the trust had been retained by the grantor.

It does not play the despot in ordaining a like rule as to trusts created in the past, at all events when in so doing it does not cast the burden backward beyond the income of the current year. *Reinecke v. Smith, supra; Corliss v. Bowers, supra; Brushaber v. Union Pacific R. R. Co.,* 240 U.S. 1; *Cooper v. United States,* 280 U.S. 409, 411; *Milliken v. United States, supra.*

The judgment is

Reversed.

MR. JUSTICE SUTHERLAND (dissenting).

MR. JUSTICE VAN DEVANTER, MR. JUSTICE MCREYNOLDS, MR. JUSTICE BUTLER, and I think otherwise.

The powers of taxation are broad, but the distinction between taxation and confiscation must still be observed. So long as the Fifth Amendment remains unrepealed and is permitted to control, Congress may not tax the property of *A* as the property of *B*, or the income of *A* as the income of *B*.

The facts here show that Wells created certain irrevocable trusts. He retained no vestige of title to, interest in, or control

over, the property transferred to the trustee. The result was a present, executed, outright gift, which could then have been taxed to the settlor. *Burnet v. Guggenheim,* 288 U.S. 280. That the property which was the subject of the gift could never thereafter, without a change of title, be taxed to the settlor is, of course, too plain for argument. To establish the contention that the income from such property, the application of which for the benefit of others had been irrevocably fixed, is nevertheless the income of the settlor and may lawfully be taxed as his property, requires something more tangible than a purpose to perform a social duty, or the recognition of a moral claim as distinguished from a legal obligation, which, we think, is not supplied by an assumption of his desire thereby to secure his own peace of mind and happiness or relieve himself from further concern in the matter. . . .

It is not accurate, we think, to say that these trusts involve the continuing exercise by the settlor of a power to direct the application of the income along predetermined channels. The exertion of power on the part of the settlor to direct such application begins and ends with the creation of the irrevocable trusts. Thereafter, the power is to be exercised automatically by the trustee under a grant which neither he nor the settlor can recall or abridge. The income, of course, is taxable, but to the trustee, not to the settlor. The well-reasoned opinion of the court below, which fully sustains respondent's contention here, renders it unnecessary to discuss the matter at greater length. We think that opinion should be sustained. It finds ample support in *Hoeper v. Tax Commission,* 284 U.S. 206, 215; *Heiner v. Donnan,* 285 U.S. 312, 326; and other decisions of this court.

Note and Problems

(A) *DuPont v. Commissioner,* 289 U.S. 685 (1933), was argued and decided at the same time as the *Wells* case. The taxpayer there had created trusts for a period of three years, with the income to be used to pay life insurance premiums. The trust had been extended for two additional three-year periods. The Court was unanimous in upholding the validity of the statute as applied to this case, saying:

"The provisions of these deeds would require a determination in favor of the Government, though *Burnet v. Wells* had been decided the other way. 'A statute may be invalid as applied to one state of facts and yet valid as applied to another.' *Dahnke-Walker Co. v. Bondurant,* 257 U.S. 282, 289. Here the grantor did not divest himself of title in any permanent or definitive way, did not strip himself of every interest in the subject matter of the trust estate. During a term of three years, the trustee was to apply the income to the preservation of the policies, and while thus applying the income was to hold the principal intact for return to the grantor unless instructed to retain it longer. The situation in its legal effect would not be greatly different if the trusts had been created for a month or from day to day. One who

retains for himself so many of the attributes of ownership is not the victim of despotic power when for the purpose of taxation he is treated as owner altogether."

(B) See Smith, "Federal Taxation of Insurance Trusts," 40 Mich.L.Rev. 207 (1941); Durant, "Trust Income and the Payment of Premiums," 27 Taxes 904 (1949).

Alimony Trusts. *Douglas v. Willcuts,* 296 U.S. 1 (1935), involved a trust which was created in connection with a divorce. The husband transferred securities to a trustee, who was to pay $15,000 a year out of the income to the wife. Excess income was to be paid to the husband, and he was to receive the principal on the death of the wife. Deficiencies in income were to be made up by the husband. The agreement provided that the trust provisions were "in lieu of, and in full settlement of alimony, and of any and all dower rights or statutory interests in the estate" of the husband. The husband had no power to revoke or modify the trust.

The Court held that the income of the trust was taxable to the husband. It said:

"No question is raised as to the constitutional power of the Congress to attribute to petitioner the income thus segregated and paid in discharge of his obligation, and that authority could not be challenged successfully. *Burnet v. Wells,* 289 U.S. 670, 677, 682, 684. The question is one of statutory construction. We think that the definitions of gross income (Revenue Acts, 1926, sec. 213; 1928, Sec. 22) are broad enough to cover income of that description. . . . In the present case, the net income of the trust fund, which was paid to the wife under the decree, stands substantially on the same footing as though he had received the income personally and had been required by the decree to make the payment directly.

"We do not regard the provisions of the statutes as to the taxation of trusts, fiduciaries and beneficiaries, (Revenue Acts, 1926, Secs. 2, 219; 1928, Secs. 161, 162) as intended to apply to cases where the income of the trust would otherwise remain, by virtue of the nature and purpose of the trust, attributable to the creator of the trust and accordingly taxable to him. These provisions have appropriate reference to cases where the income of the trust is no longer to be regarded as that of the settlor, and we find no warrant for a construction which would preclude the laying of the tax against the one who through the discharge of his obligation enjoys the benefit of the income as though he had personally received it."

At the same time, the Court held that the settlor was taxable on the income of an irrevocable trust where it was provided that the income was to be used for the support of his minor children (*Helvering v. Schweitzer,* 296 U.S. 551 (1935); *Helvering v. Stokes,* 296 U.S. 551 (1935)), and where the income was to be used to pay certain specified debts of the settlor. *Helvering v. Blumenthal,* 296 U.S. 552 (1935).

In later cases, the Court held that the income would not be taxable to the husband, where the trust was accepted in full and complete discharge of all obligation on the part of the husband

so that he had no obligation to make up deficiencies, and there was no power in the Court under the applicable state law to revise his obligation in any way. *Helvering v. Fuller,* 310 U.S. 69 (1940). But the burden was left on the husband to show that he had no continuing obligation. *Helvering v. Fitch,* 309 U.S. 419 (1940);[1] *Helvering v. Leonard,* 310 U.S. 80 (1940). *Cf. Pearce v. Commissioner,* 315 U.S. 543 (1942).

In 1942, Congress made alimony deductible by the payor, and taxable to the recipient. See the provisions now found in secs. 71 and 215 of the 1954 Code. A corresponding amendment was made at that time with respect to trust income by adding what is now sec. 682 of the 1954 Code. Thus the actual decision in *Douglas v. Willcuts* is no longer law. For a discussion of the present situation, see Gornick, "Alimony and the Income Tax," 29 Corn.L.Q. 28 (1943); Dean, "The Alimony Trust," 28 Taxes 911 (1950); "Tax Aspects of Alimony Trusts," 66 Yale L.J. 881 (1957).

(A) In *Morsman v. Commissioner,* 90 F.2d 18 (C.C.A.8th, 1937), cert. den. 302 U.S. 701 (1937), noted in 51 Harv.L.Rev. 176 (1937), the petitioner declared himself sole trustee of shares of stock, with full power of management and investment. The trust instrument provided that the income should be accumulated for five years and then paid to the petitioner for life, with the remainder to his issue. If he left no issue, then the principal was to go to his widow; and if there was no widow, then to his heirs. He was unmarried, without issue. He sold the stock at a profit and then transferred the trust to a successor trustee, in accordance with the trust instrument. The successor reported the profit on the sale as trust income. It was held that the income was taxable to the settlor on the ground that no valid trust had been created. See the discussion in 1 Scott, Trusts sec. 99, 2 Scott, Trusts sec. 112.1 (2d ed. 1956).

HELVERING v. CLIFFORD

Supreme Court of the United States, 1940. 309 U.S. 331.

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

In 1934 respondent declared himself trustee of certain securities which he owned. All net income from the trust was to be held for the "exclusive benefit" of respondent's wife. The trust was for a term of five years, except that it would terminate earlier on the death of either respondent or his wife. On ter-

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[1] In this case, the Court found that it was not clear under the Iowa law that the Iowa court, where the divorce had been granted, had no power to modify the property settlement. Since the husband had not sustained the burden of showing that he was completely discharged, he was held taxable on the income of the trust for 1933. Thereafter, the taxpayer started a proceeding in Iowa in which it was held that the Iowa court had no power to modify the settlement. Fitch v. Fitch, 229 Iowa 349, 294 N.W. 577 (1940). It was then held that the husband was not taxable on the income of the trust for 1934 and 1935. F. W. Fitch, 43 B.T.A. 773 (1941). The Commissioner acquiesced in this decision. 1941-1 Cum.Bull. 4.

mination of the trust the entire corpus was to go to respondent, while all "accrued or undistributed net income" and "any proceeds from the investment of such net income" was to be treated as property owned absolutely by the wife. During the continuance of the trust respondent was to pay over to his wife the whole or such part of the net income as he in his "absolute discretion" might determine. And during that period he had full power (a) to exercise all voting powers incident to the trusteed shares of stock; (b) to "sell, exchange, mortgage, or pledge" any of the securities under the declaration of trust "whether as part of the corpus or principal thereof or as investments or proceeds and any income therefrom, upon such terms and for such consideration" as respondent in his "absolute discretion may deem fitting"; (c) to invest "any cash or money in the trust estate or any income therefrom" by loans, secured or unsecured, by deposits in banks, or by purchase of securities or other personal property "without restriction" because of their "speculative character" or "rate of return" or any "laws pertaining to the investment of trust funds"; (d) to collect all income; (e) to compromise, etc., any claims held by him as trustee; (f) to hold any property in the trust estate in the names of "other persons or in my own name as an individual" except as otherwise provided. Extraordinary cash dividends, stock dividends, proceeds from the sale of unexercised subscription rights, or any enhancement, realized or not, in the value of the securities were to be treated as principal, not income. An exculpatory clause purported to protect him from all losses except those occasioned by his "own wilful and deliberate" breach of duties as trustee. And finally it was provided that neither the principal nor any future or accrued income should be liable for the debts of the wife; and that the wife could not transfer, encumber, or anticipate any interest in the trust or any income therefrom prior to actual payment thereof to her.

It was stipulated that while the "tax effects" of this trust were considered by respondent they were not the "sole consideration" involved in his decision to set it up, as by this and other gifts he intended to give "security and economic independence" to his wife and children. It was also stipulated that respondent's wife had substantial income of her own from other sources; that there was no restriction on her use of the trust income, all of which income was placed in her personal checking account, intermingled with her other funds, and expended by her on herself, her children and relatives; that the trust was not designed to relieve respondent from liability for family or household expenses and that after execution of the trust he paid large sums from his personal funds for such purposes.

Respondent paid a federal gift tax on this transfer. During the year 1934 all income from the trust was distributed to the wife who included it in her individual return for that year. The Commissioner, however, determined a deficiency in respondent's return for that year on the theory that income from the trust was taxable to him. The Board of Tax Appeals sustained that redetermination. 38 B.T.A. 1532. The Circuit Court of Appeals reversed. 8 Cir., 105 F.2d 586. We granted certiorari because of the importance to the revenue of the use of such short term trusts in the reduction of surtaxes.

Sec. 22(a) of the Revenue Act of 1934, 48 Stat. 680, 686, includes among "gross income" all "gains, profits, and income derived . . . from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." The broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories. *Cf. Helvering v. Midland Mutual Life Insurance Co.,* 300 U.S. 216. Hence our construction of the statute should be consonant with that purpose. Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor after the trust has been established may still be treated, under this statutory scheme as the owner of the corpus. See *Blair v. Commissioner,* 300 U.S. 5, 12. In absence of more precise standards or guides supplied by statute or appropriate regulations,[1] the answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation. And where the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more by devices which, though valid under state law, are not conclusive so far as section 22(a) is concerned.

In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over

[1] We have not considered here Art. 166–1 of Treasury Regulations 86 promulgated under sec. 166 of the 1934 Act and in 1936 amended (T.D. 4629) so as to rest on sec. 22(a) also, since the tax in question arose prior to that amendment.

the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of section 22(a).

So far as his dominion and control were concerned it seems clear that the trust did not effect any substantial change. In substance his control over the corpus was in all essential respects the same after the trust was created, as before. The wide powers which he retained included for all practical purposes most of the control which he as an individual would have. There were, we may assume, exceptions, such as his disability to make a gift of the corpus to others during the term of the trust and to make loans to himself. But this dilution in his control would seem to be insignificant and immaterial, since control over investment remained. If it be said that such control is the type of dominion exercised by any trustee, the answer is simple. We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. For as a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property. That might not be true if only strictly legal rights were considered. But when the benefits flowing to him indirectly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had. To exclude from the aggregate those indirect benefits would be to deprive section 22(a) of considerable vitality and to treat as immaterial what may be highly relevant considerations in the creation of such family trusts. For where the head of the household has income in excess of normal needs, it may well make but little difference to him (except income-taxwise) where portions of that income are routed—so long as it stays in the family group. In those circumstances the all-important factor might be retention by him of control over the principal. With that control in his hands he would keep direct command over all that he needed to remain in substantially the same financial situation as before. Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue. Thus, where, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact

committed reversible error when they found that the husband was the owner of the corpus for the purposes of section 22(a). To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements.

The bundle of rights which he retained was so substantial that respondent cannot be heard to complain that he is the "victim of despotic power when for the purpose of taxation he is treated as owner altogether." See *Du Pont v. Commissioner,* 289 U.S. 685, 689.

We should add that liability under section 22(a) is not foreclosed by reason of the fact that Congress made specific provision in section 166, for revocable trust, but failed to adopt the Treasury recommendation in 1934, *Helvering v. Wood,* 308 U.S. 344, that similar specific treatment should be accorded income from short term trusts. Such choice, while relevant to the scope of section 166, *Helvering v. Wood, supra,* cannot be said to have subtracted from section 22(a) what was already there. Rather, on this evidence it must be assumed that the choice was between a generalized treatment under section 22(a) or specific treatment under a separate provision [2] (such as was accorded revocable trusts under section 166); not between taxing or not taxing grantors of short term trusts. In view of the broad and sweeping language of section 22(a), a specific provision covering short term trusts might well do no more than to carve out of section 22(a) a defined group of cases to which a rule of thumb would be applied. The failure of Congress to adopt any such rule of thumb for that type of trust must be taken to do no more than to leave to the triers of fact the initial determination of whether or not on the facts of each case the grantor remains the owner for purposes of section 22(a).

In view of this result we need not examine the contention that the trust device falls within the rule of *Lucas v. Earl,* 281 U.S. 111, and *Burnet v. Leininger,* 285 U.S. 136, relating to the assignment of future income; or that respondent is liable under section 166, taxing grantors on the income of revocable trusts.

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2 As to the disadvantage of a specific statutory formula over more generalized treatment see Vol. I, Report, Income Tax Codification Committee (1936), a committee appointed by the Chancellor of the Exchequer in 1927. In discussing revocable settlements the Committee stated, p. 298: "This and the three following clauses reproduce section 20 of the Finance Act, 1922, an enactment which has been the subject of much litigation, is unsatisfactory in many respects, and is plainly inadequate to fulfill the apparent intention to prevent avoidance of liability to tax by revocable dispositions of income or other devices. We think the matter one which is worthy of the attention of Parliament."

The judgment of the Circuit Court of Appeals is reversed and that of the Board of Tax Appeals is affirmed.

Reversed.

MR. JUSTICE ROBERTS, dissenting:

I think the judgment should be affirmed.

The decision of the court disregards the fundamental principle that legislation is not the function of the judiciary but of Congress.

In every revenue act from that of 1916 to the one now in force a distinction has been made between income of individuals and income from property held in trust. It has been the practice to define income of individuals, and, in separate sections, under the heading "Estates and Trusts," to provide that the tax imposed upon individuals shall apply to the income of estates or of any kind of property held in trust. A trust is a separate taxable entity. The trust here in question is a true trust. . . .

The Treasury had asked that there should also be included in the [1934] act a provision taxing to the grantor income from short term trusts. After the House Ways and Means Committee had rendered a report on the proposed bill, the Treasury, upon examination of the report, submitted a statement to the Committee containing recommendations for additional provisions; amongst others, the following: "(6) The income from short-term trusts and trusts which are revocable by the creator at the expiration of a short period after notice by him should be made taxable to the creator of the trust." Congress adopted an amendment to cover the one situation but did not accept the Treasury's recommendation as to the other. The statute, as before, clearly provided that the income from a short term irrevocable trust was taxable to the trust, or the beneficiary, and not to the grantor. . . .

To construe either section 166 or section 22(a) of the statute as justifying taxation of the income to respondent in this case is, in my judgment, to write into the statute what is not there and what Congress has omitted to place there.

If judges were members of the legislature they might well vote to amend the act so as to tax such income in order to frustrate avoidance of tax but, as judges, they exercise a very different function. They ought to read the act to cover nothing more than Congress has specified. Courts ought not to stop loopholes in an act at the behest of the Government, nor relieve from what they deem a harsh provision plainly stated, at the behest of the taxpayer. Relief in either case should be sought in another quarter.

No such dictum as that Congress has in the income tax law attempted to exercise its power to the fullest extent will justify

the extension of a plain provision to an object of taxation not embraced within it. If the contrary were true, the courts might supply whatever they considered a deficiency in the sweep of a taxing act. I cannot construe the court's opinion as attempting less. . . .

If some short term trusts are to be treated as non-existent for income tax purposes, it is for Congress to specify them.

MR. JUSTICE MCREYNOLDS joins in this opinion.[3]

Notes and Problems

(A) Note that the *Clifford* case (and its progenitor *Douglas v. Willcuts*) were decided on the basis of the "general language" of the definition of gross income in former section 22(a)—now found in the first part of sec. 61(a) of the 1954 Code. Under the 1954 Code it is for the first time expressly provided that the "general language" shall have no application to income of trusts. See the last sentence of sec. 671.

Applications of the *Clifford* doctrine may be seen in the following cases:

Power to Dispose of Income to Others

(B) A transferred property to a trustee on trust for X for life with remainder to Y. A reserved the power to change the beneficiaries in any way, except that he could not make himself beneficiary, or otherwise use the income for his benefit. (This is sometimes known as a "spray" power.) It was held that A was taxable on the income from the trust. *Commissioner v. Buck,* 120 F.2d 775 (C.C.A.2d, 1941). (For the present law, see sec. 674 of the 1954 Code.)

See Baer, "Keeping Control of the Spray Trust in the Family: Income Tax Problems," 34 Taxes 734 (1956).

Power in Some One Other Than the Grantor

(C) W created a trust for her children. She reserved no beneficial interest, no power to revoke, no other power. She did, however, confer on H the power to terminate the trust at any time and take the principal of the trust for his own benefit. H did not exercise the power. It was held that the income of the trust was taxable to H. *Richardson v. Commissioner,* 121 F.2d 1 (C.C.A.2d, 1941). Such a power is sometimes called a "Richardson" power. (For the present law, see sec. 678 of the 1954 Code.)

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3 Discussions of the Clifford problem may be found in Pavenstedt, "The Broadened Scope of Section 22(a): The Evolution of the Clifford Doctrine," 51 Yale L.J. 213 (1941); Case, "The Circuit Courts of Appeals Examine the Clifford Doctrine," 7 Md.L.Rev. 201 (1943); Magill, "What Shall Be Done With the Clifford Case?" 45 Col.L.Rev. 111 (1945); Soll, "Intra-Family Assignments: Attribution and Realization of Income," 6 Tax L.Rev. 435, 7 Tax L.Rev. 61 (1951).

Power to "Take" Income

(D) A died, leaving property to trustees upon trust to pay the income to X for life with remainder to Y. The will provided, however, that as long as B lived the income should be paid to him in whole or in part if he asked for it. It was held that the income was taxable to B whether he asked for it or not. *Mallinckrodt v. Nunan,* 146 F.2d 1 (C.C.A.8th, 1945); *Frank v. Commissioner,* 145 F.2d 413 (C.C.A.3d, 1944). See also *Spies v. United States.* 180 F.2d 336 (C.A.8th, 1950), where three trustees had power to distribute income among several beneficiaries including themselves. (This is also now covered by sec. 678 of the 1954 Code.) See Stern, "A Tax Trap for the Family Trustee," 33 Taxes 594 (1955).

In *Smith v. Commissioner,* 265 F.2d 834 (C.A.5th, 1959), it appeared that a man had left his property to his wife, authorizing her to use any of the income she wanted, and providing that all of the property left on her death was to be distributed to his heirs. The wife lived frugally, using only a portion of the income, and she contended that she was taxable only on the amount that she used, and that the rest was held in trust for the heirs. It was held that she was taxable on all of the income from the property.

Deductions

(E) Does the *Clifford* doctrine work both ways? Is the settlor of a *Clifford* trust entitled to deduct a loss sustained by the trust? See *Buhl v. Commissioner,* 45 B.T.A. 274 (1941). Is this covered now by sec. 671 of the 1954 Code?

(F) Where the grantor of an irrevocable trust becomes taxable on its income, has he any right to recover the tax from the trustee? If no such provision is made in the trust instrument, can the courts modify the trust on the ground of hardship, or any other ground? Such a modification was allowed in *Hardy v. Bankers Trust Co.,* 137 N.J.Eq. 352, 44 A.2d 839 (1945), noted in 46 Col.L.Rev. 493 (1946). Suppose the taxpayer is insolvent. How can the Government collect the tax? [1] Would a provision for apportionment or allocation of the tax with respect to trust income be feasible?

In *Stone v. Stone,* 319 Mich. 194, 29 N.W.2d 271 (1947), a settlor created what purported to be an irrevocable trust for his children. It was unsuccessful in diverting the tax on the income from him. The state court then held that he might revoke the trust because of mistake. But see *Lowry v. Collector,* 322 Mich. 532, 34 N.W.2d 60 (1948). The problems are discussed in Guterman, "Unravelling Transactions with Frustrated Tax Motives," 4 Tax L.Rev. 437 (1949).

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[1] In Fitzgerald v. Commissioner, 4 T.C. 494 (1944) the settlor was a nonresident alien. It had previously been determined that the income was not taxable to the beneficiary. Princess Lida of Thurn and Taxis, 37 B.T.A. 41 (1938). The Government unsuccessfully sought to collect the tax from the trustee either as a withholding agent or as a fiduciary.

Support Trusts

(G) *Helvering v. Stuart,* 317 U.S. 154 (1942), involved a trust created by A for the benefit of his children. The trustees had power either to accumulate the income during the minority of the children, or to apply it for the maintenance and support of the children. The Court held that the entire income of the trust was taxable to the grantor whether used for their support or not. The immediate result was the enactment, by sec. 134 of the Revenue Act of 1943,[2] of the provision now found in sec. 677(b) of the 1954 Code. The Regulations under this are secs. 1.677(a)(1) through 1.677(b)–1 of the Income Tax Regulations. See also sec. 674(b)(7)(B). Consider, Samuels, "Beware of Trusts for Dependents," 37 Taxes 1009 (1959).

The Clifford Regulations

The application of the *Clifford* case involved great uncertainty and a vast amount of litigation. In order to help to clarify the situation, the Treasury, on December 29, 1945, issued what were known as the Clifford Regulations. T.D. 5488, 1946–1 Cum.Bull. 19, adding the provisions which for many years appeared in secs. 29.22(a)–21, 29.22(a)–22, and 29.166–2 of Regulations 111, and the corresponding provisions of Regulations 118.

The general purpose of the Clifford Regulations was to set up a series of clear tests defining the situations in which the income of a trust would be taxable to the grantor. At first there was considerable hostility to the Clifford Regulations among taxpayer's lawyers,[3] but in time, as they became used to the provisions, and recognized the usefulness of having some clear and definite rules to use in advising clients and drawing wills and trusts, the Clifford Regulations were quite generally accepted as a desirable improvement in the tax law.[4] One case apparently held that the Regulations were unconstitutional (*Commissioner v. Clark,* 202 F.2d 94 (C.A.7th, 1953)); but this arose on somewhat unusual facts and it did not attract a following.[5]

Rev.Rul. 54–516, 1954–2 Cum.Bull. 54, decided under the *Clifford* regulations, involved a transfer of real estate by A to himself as trustee, with his minor children as beneficiaries. The trust was to continue until the youngest of the children, or the survivor of them, became 21 years of age. With certain exceptions, the income of the trust was to be accumulated during its existence. The grantor retained no reversionary interest, and no

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2 See Guterman, "The Federal Income Tax and Trusts for Support—The Stuart Case and Its Aftermath", 57 Harv.L.Rev. 479 (1944).

3 For discussions, see Guterman, "The New Clifford Regulations," 1 Tax L.Rev. 379 (1946); Alexandre, "A Case Method Restatement of the New Clifford Regulations," 3 Tax L.Rev. 189 (1947); Pavenstedt, "The Treasury Legislates: The Distortion of the Clifford Rule," 2 Tax L.Rev. 7 (1946); Eisenstein, "The Clifford Regulations and the Heavenly City of Legislative Intention," 2 Tax L.Rev. 327 (1947); Kennedy, "Short Term Trusts Today," 30 Taxes 1006 (1952).

4 See Casner, "Estate Planning under the Revenue Act of 1948—The Regulations," 63 Harv.L.Rev. 99 (1949).

5 See "The Seventh Circuit v. The Clifford Regulations: 'Due Process' Emancipates the Tax Avoider," 62 Yale L.J. 1236 (1953).

power to control the beneficial enjoyment of the income or principal. On the termination of the trust, the principal and accumulated income were to be distributed to the beneficiaries in equal shares. It was ruled that the income was taxable to the trust and not to A. However, it was pointed out that any income distributed or applied for the support of a minor child, and any income used to pay principal or interest on a mortgage on the trust realty, if the grantor was liable on the mortgage, would be taxable to him.

The Enactment of the Clifford Rules

In the 1954 Code, after a period of seasoning, so to speak, in the Regulations, the Clifford rules, with some modifications were put into the statute. These are included in the provisions now found in secs. 671–678 of the 1954 Code. The Regulations will still be applicable for 1953 and prior years. The statutory provisions will govern for 1954 and thereafter. Thus the evolution of the law in this complicated field can be traced from case to regulation to statute.

The student should carefully study the provisions of secs. 671 to 678 of the Code, and the corresponding provisions of the Income Tax Regulations. As elsewhere, there is no substitute for actual contact with the statute, and this is especially true in this area. It will be noted that the statute (as in the case of the Regulations) sets up a three-fold scheme for determining when the income of an irrevocable trust is taxable to the grantor. This result will follow if:

(1) The trust has a short term. Sec. 673. Ordinarily the income will be taxable to the grantor if the trust principal or income will revert to the grantor within ten years from the time of its creation. Note that the period is only 2 years where the income is payable to certain kinds of charities. (But the grantor gets no deduction for a charitable gift in such a case if his reversionary interest is worth more than 5% of the value of the property. Sec. 170(b) of the 1954 Code.)

(2) The grantor or another has a power to control the disposition of the income or the principal of the trust. Sec. 674.

(3) The grantor or another has certain administrative powers. Sec. 675.

Is this a satisfactory solution of the problem?

For discussions under the 1954 Code, see Winton, "Taxation of Nongrantors under Trusts for Support of Their Dependents," 33 Taxes 804 (1955); Nance, "Taxation of Trust Income to Grantors and Others as Substantial Owners of Property," 33 Taxes 899 (1955); Monrad, "Power of Disposition," 34 Taxes 693 (1956); Johnson, "Trusts and the Grantor," 36 Taxes 869 (1958); Westfall, "Trust Grantors and Section 674: Adventures in Income Tax Avoidance," 60 Col.L.Rev. 326 (1960).

For consideration of the question of trusts for charitable and other purposes, see Tomson and Jaffe, "The Short-Term Trust and Charitable Contributions," 35 Taxes 350 (1957); Yohlin, "The Short Term Trust—A Respectable Tax Saving Device," 14 Tax L.Rev. 109 (1958).

Correlation and Integration

Although the income tax provisions with respect to trusts are now worked out in considerable detail, the provisions of the estate and gift taxes are not so well developed and in some cases are not consistent with those in the income tax provisions. For instance, the grantor of an insurance trust (as in *Burnet v. Wells*) is taxable on its income, but may have to pay a gift tax when he creates the trust. A good deal of consideration has been given to the question whether the income tax with respect to trusts can be correlated with the estate and gift taxes. The problem has been discussed in Warren, "Correlation of Gift and Estate Taxes," 55 Harv.L.Rev. 1 (1941); Greenfield, "Correlation of Federal Income, Estate and Gift Taxes," 16 Temple L.Q. 194 (1942); Griswold, "A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions with Respect to Trusts and Other Transfers," 56 Harv.L.Rev. 337 (1942); Griswold, "Coordinating Federal Income, Estate and Gift Taxes," 22 Taxes 6 (1944).

The question of correlation and integration of income, estate, and gift taxes is dealt with in detail in a Report on Federal Estate and Gift Taxes (1947), prepared by an Advisory Committee for the Treasury Department. See "The Proposed Revision of Federal Tax Incidents of Property Transfers," 60 Harv.L.Rev. 1120 (1947); Platt, "Integration and Correlation," 3 Tax L.Rev. 59 (1947); Wales, "Consistency in Taxes—The Rationale of Integration and Correlation," 3 Tax L.Rev. 173 (1947).

See also DeWind, "The Approaching Crisis in Estate and Gift Taxation," 38 Calif.L.Rev. 79 (1950).

Income Not Taxable to the Grantor

Secs. 641–668 of the 1954 Code

Secs. 1.641–1 through 1.668(b)–2 of the Income Tax Regulations

Heretofore the cases involving trust income in this Chapter have been ones in which the question was whether the income was taxable to the grantor (or to someone else, as in the *Richardson* case) on the ground that he was the "owner" of it. There are, however, three possible places where tax liability may rest with respect to trust income—the settlor, the trustee, and the beneficiary. From here on we will consider the question between the trustee and the beneficiary. In these cases it is clear that the settlor is not taxable. Often this is because the settlor is dead—the trust is testamentary, and it is not possible to tax the settlor. In other cases, though, it is clear that the settlor, though living, is not taxable. He does not come within any of the rules now stated in secs. 671–678 of the 1954 Code. It remains necessary to determine, in many cases, how the income should be taxed, whether to the beneficiary or to the trustee.

The statutory provisions are divided so as to deal first with what might be called "simple trusts" (secs. 651 and 652), and then with more "complex trusts," where the trustee may accumulate income or may distribute principal. Secs. 661–668 of the 1954 Code. This general arrangement and plan follows rather closely the proposals of the American Law Institute Income Tax Project. For the background of these provisions, see Holland, Kennedy, Surrey and Warren, "Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates," 53 Col.L.Rev. 316 (1953).

IRWIN v. GAVIT

Supreme Court of the United States, 1925. 268 U.S. 161.

MR. JUSTICE HOLMES delivered the opinion of the Court.

This is a suit to recover taxes and penalties exacted by the Collector under the Income Tax Act of October 3, 1913, c. 16, Section II, A. subdivisions 1 and 2; B. D. and E. 38 Stat. 114, 166, *et seq.* The Collector demurred to the complaint. The demurrer was overruled and judgment given for the plaintiff by the District Court, 275 F. 643, and the Circuit Court of Appeals, 295 F. 84. A writ of certiorari was granted by this Court. 264 U.S. 579.

The question is whether the sums received by the plaintiff under the will of Anthony N. Brady in 1913, 1914 and 1915, were income and taxed. The will, admitted to probate August 12, 1913, left the residue of the estate in trust to be divided into six equal parts, the income of one part to be applied so far as deemed proper by the trustees to the education and support of the testator's granddaughter, Marcia Ann Gavit, the balance to be divided into two equal parts and one of them to be paid to the testator's son-in-law, the plaintiff, in equal quarter-yearly payments during his life. But on the granddaughter's reaching the age of twenty-one or dying the fund went over, so that, the granddaughter then being six years old, it is said, the plaintiff's interest could not exceed fifteen years. The Courts below held that the payments received were property acquired by bequest, were not income and were not subject to tax.

The statute in Section II, A, subdivision 1, provides that there shall be levied a tax "upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States." If these payments properly may be called income by the common understanding of that word and the statute has failed to hit them it has missed so much of the general purpose that it expresses at the start. Congress intended to use its power to the full extent. *Eisner v. Macomber,* 252 U.S. 189, 203. By B. the net income is to include "gains or profits and income derived from any source whatever, including the income

from but not the value of property acquired by gift, bequest, devise or descent." By D. trustees are to make "return of the net income of the person for whom they act, subject to this tax," and by E. trustees and others having the control or payment of fixed or determinable gains, &c., of another person who are required to render a return on behalf of another are "authorized to withhold enough to pay the normal tax." The language quoted leaves no doubt in our minds that if a fund were given to trustees for *A* for life with remainder over, the income received by the trustees and paid over to *A* would be income of *A* under the statute. It seems to us hardly less clear that even if there were a specific provision that *A* should have no interest in the corpus, the payments would be income none the less, within the meaning of the statute and the Constitution, and by popular speech. In the first case it is true that the bequest might be said to be of the corpus for life, in the second it might be said to be of the income. But we think that the provision of the act that exempts bequests assumes the gift of a corpus and contrasts it with the income arising from it, but was not intended to exempt income properly so-called simply because of a severance between it and the principal fund. No such conclusion can be drawn from *Eisner v. Macomber,* 252 U.S. 189, 206, 207. The money was income in the hands of the trustees and we know of nothing in the law that prevented its being paid and received as income by the donee.

The Courts below went on the ground that the gift to the plaintiff was a bequest and carried no interest in the corpus of the fund. We do not regard those considerations as conclusive, as we have said, but if it were material a gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund. Apart from technicalities we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it. The fund is appropriated to the production of the same result whichever form the gift takes. Neither are we troubled by the question where to draw the line. That is the question in pretty much everything worth arguing in the law. *Hudson County Water Co. v. McCarter,* 209 U.S. 349, 355. Day and night, youth and age are only types. But the distinction between the cases put of a gift from the corpus of the estate payable in instalments and the present seems to us not hard to draw, assuming that the gift supposed would not be income. This is a gift from the income of a very large fund, as income. It seems to us immaterial that the same amounts might receive a different color from their source. We are of opinion that quarterly payments, which it was hoped would last for fifteen years, from the income of an estate intended for the plaintiff's child, must be regarded as income within the meaning of the Constitution and the law. It is said that the tax laws should be construed favorably

for the taxpayers. But that is not a reason for creating a doubt or for exaggerating one when it is no greater than we can bring ourselves to feel in this case.

Judgment reversed.

MR. JUSTICE SUTHERLAND, dissenting.

By the plain terms of the Revenue Act of 1913, the value of property acquired by gift, bequest, devise, or descent is not to be included in net income. Only the income derived from such property is subject to the tax. The question, as it seems to me, is really a very simple one. Money, of course, is property. The money here sought to be taxed as income was paid to respondent under the express provisions of a will. It was a gift by will,—a bequest. *United States v. Merriam,* 263 U.S. 179, 184. It, therefore, fell within the precise letter of the statute; and, under well settled principles, judicial inquiry may go no further. The taxpayer is entitled to the rigor of the law. There is no latitude in a taxing statute,—you must adhere to the very words. *United States v. Merriam, supra,* pp. 187–188.

The property which respondent acquired being a bequest, there is no occasion to ask whether, before being handed over to him, it had been carved from the original corpus of, or from subsequent additions to, the estate. The corpus of the estate was not the legacy which respondent received, but merely the source which gave rise to it. The money here sought to be taxed was not the fruits of a legacy; it was the legacy itself. *Matter of Stanfield,* 135 N.Y. 292, 294.

With the utmost respect for the judgment of my brethren to the contrary, the opinion just rendered, I think without warrant, searches the field of argument and inference for a meaning which should be found only in the strict letter of the statute.

MR. JUSTICE BUTLER concurs in this dissent.

Notes

In *Burnet v. Whitehouse,* 283 U.S. 148 (1931), the will provided an annuity of $5,000, payable out of principal if necessary. The annuity was in fact paid out of income. The Court held that the beneficiary was nevertheless not taxable. It said: "Here the gift did not depend upon income but was a charge upon the whole estate during the life of the legatee to be satisfied like any ordinary bequest."

In *Helvering v. Butterworth,* 290 U.S. 365 (1933), the Court held that the rule of *Irwin v. Gavit* applied even where the life beneficiary was the widow of the decedent, and had, in a sense, purchased the provision made for her by giving up her statutory share or dower interest in the decedent's estate. The actual

decision in the case was that the income was not taxable to the trustee because it was taxable to the widow-beneficiary. But in the case of *Helvering v. Pardee,* decided in the same opinion, the provision for the widow was an annuity, like that involved in the *Whitehouse* case. The Court held that the trustee was not entitled to a deduction for the annuity payment, with the result that the trust income was taxable to the trust.[1]

The rule of the *Whitehouse* and *Pardee* cases was reversed by sec. 111(a) of the Revenue Act of 1942, which added the provision now found in sec. 102(b) of the 1954 Code so as to make taxable to the beneficiary so much of the payment from an annuity trust as is actually payable out of income, or is in fact paid out of income.[2] See also secs. 662(a)(2) and 663(a) of the 1954 Code.

Problem

T created a trust in 1911. The trust instrument provided that on T's death the sum of $7,000 should be paid to her niece. This sum was to be paid out of the income or the principal of the trust. T died in 1947, and the trustee paid $7,000 to the niece. The trust had more than $7,000 in income available at the time of the payment. Is the payment taxable as income to the niece? *Miriam C. Lindau,* 21 T.C. 911 (1954). Note carefully the language of secs. 102(b) and 663(a)(1) of the 1954 Code.

Problems under the 1939 Code—Background for the 1954 Provisions

The basic objective in the taxation of trust income is fairly clear. In many cases the trust is simply a conduit. The trustee receives the income and pays it out to the beneficiary. In such a case the income should be taxable to the beneficiary and not to the trustee. Suppose, however, a trust in which the trustee is required to accumulate the income and to pay it out to such of the children of X as are living twenty years after the grantor's death. In such a case no income is paid out currently, it cannot be told whether any particular beneficiary will ever get any of the income, and the income will necessarily escape current tax unless it is taxed to the trustee.

The general scheme which was devised to meet this situation was to say that the trust is a taxpayer, with the trustee obligated to pay its tax. The same rule was also applied in case of estates in process of administration by an executor or administrator. The taxable income of the estate or trust was computed in the same manner as in the case of an individual. But the trust was allowed an additional deduction for the amount of its income

1 The problems are discussed in Hess and Guterman, "Annuity Trusts and the Federal Income Tax," 55 Harv.L.Rev. 329 (1942). See also "Taxation of Sums Received Under Rights to Future Periodic Payments," 44 Yale L.J. 660 (1935); "The Power to Invade Corpus in Federal Income Taxation of Trusts," 49 Yale L.J. 1496 (1940).

2 The same development occurred in Canada. In Toronto General Trusts Corp. v. Minister of Nat. Rev., [1936] Ex.C.R. 172, it was held that income paid to the beneficiary of an annuity trust was not taxable to the beneficiary. This result was overturned by Can.Stat. (1938) c. 48.

which is required to be distributed currently.[1] Then the amount so deductible was included in the income of the beneficiary, whether actually distributed or not. But income not required to be distributed was taxed to the trust, at its income tax brackets. Such income became "tax paid" income and could be distributed to a beneficiary in a later year without further tax liability.

If this was all there was in the statute, there would be a great opportunity for tax avoidance. In many cases, the beneficiary would be in high tax brackets. If the income can be made taxable to the trust, it might be taxable in much lower brackets resulting in a large saving in tax. Situations showing the possibilities here are illustrated by the two following cases:

(1) A trust was created under which A was to get the income for each year on January 3 of the following year, if he was then living; otherwise the income was to be paid to B. It was held that the income was taxable to the trust and not to the beneficiary, since it was not distributable in the year it was received by the trustee. *Commissioner v. Dean,* 102 F.2d 699 (C.C.A. 10th, 1939), noted in 34 Ill.L.Rev. 90 (1939). Suppose the trust provided that the trustee might in his discretion distribute the income currently or accumulate it until January 3 of the following year, in which case it would be then payable to A if living, otherwise to B. Under such a trust, with a simple statutory provision, the trustee could determine each year, as might be most advantageous, whether the income should be taxable to A or to the trust.

(2) A trust is created to accumulate income during the minority of the beneficiary, and to pay all of the accumulated income to the beneficiary when he reached 21. It was held that the income for the year in which the beneficiary reached 21, and received the income, was taxable to the trust and not to the beneficiary. *Spreckels v. Commissioner,* 101 F.2d 721 (C.C.A. 9th, 1939); *Commissioner v. Clark,* 134 F.2d 159 (C.C.A.2d, 1943). Similarly, it was held that income distributed upon the closing of an estate was taxable to the estate rather than to the beneficiary. See *Wilcox v. Commissioner,* 43 B.T.A. 931 (1941), aff'd 137 F.2d 136 (C.C.A.9th, 1943).

In an effort to deal with these problems Congress in 1942 amended sec. 162(b) of the Internal Revenue Code of 1939, and added extraordinarily complicated provisions in sec. 162(d).[2] The general purport of these provisions was to tax to the beneficiary (1) all income actually distributed within the first sixty-five days of the following taxable year, and (2) all distributions to a beneficiary to the extent that the trust had income within

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[1] The trust or estate was also entitled to an additional deduction for all amounts *paid or permanently set aside* for charities, without limitation as to amount. When is income "permanently set aside"? See Merchants Nat. Bank v. Commissioner, 320 U.S. 256 (1943).

[2] These provisions were critically discussed with recommendations for a complete change, in Rabkin and Johnson, "Trust and Beneficiary under the Income Tax," 1 Tax L.Rev. 117 (1946). See also Fenn, "The Present Method of Taxing Trust Income: A Criticism and Proposed Revision," 51 Yale L.J. 1143 (1942).

the preceding twelve months' period. An application of the latter rule is shown in the following case:

Smith v. Westover, 191 F.2d 1003 (C.A.9th, 1951), involved a testamentary trust. The will directed that the income should all be added to principal. It also directed that there should be paid to T, during her life, a sum equal to 5% of the value of the corpus. In 1944, the trust income was about $24,000, and the 5% distribution to T was about $18,000. T contended that the $18,000 was a bequest of principal of the trust and not taxable to her. The court held that the distribution was taxable as income to T, under sec. 162(d)(1) of the Code, and it rejected a contention that the statute as so applied was unconstitutional.

The rules of the statute from 1942 to 1954 were stated in very complicated terms, and it was often difficult to understand their effect. There were rumors that there were areas in the country where they were largely disregarded, simply because of general failure to know what they meant.

A SYNOPSIS OF THE 1954 PROVISIONS

Under the 1939 Code, income was in effect "traced" from the trust to the beneficiary. If the income distributed was current income it was taxed to the beneficiary; but if it was past income on which the trust had already paid tax, then it was not taxable to the beneficiary, subject to the 65 day and twelve month rules. Under the 1954 Code, this is changed for a rigid rule—somewhat like the rule that a corporate distribution always comes from its "earnings and profits," to the extent that it has any, and from its most recently accumulated earnings and profits, before it can make a distribution of capital to its shareholders. For this purpose, the 1954 Code develops the concept of "distributable net income." Sec. 643(a). Note that there is also a definition of "income," so that it means in effect "income for trust law purposes." Sec. 643(b). All distributions are from distributable net income to the extent that such income is available. Secs. 651(b), and especially 661(a). There is an exception for a gift or bequest of property or of a specified sum of money. Sec. 663.

The 1954 Code specifically provides that the income distributed takes the same character in the hands of the beneficiary that it had when received by the trust. Secs. 652(b) and 661(b). Thus it is capital gain, or tax exempt interest, or dividends, or ordinary income to the beneficiary as if he had received it directly. If there are several beneficiaries, this is determined pro rata or in accordance with their respective interests in the trust.

Because of the "distributable net income" concept, the trust or the beneficiary now gets the benefit of deductions that used to be lost under the 1939 Code. The beneficiary is not taxed on what he receives, but on his share of the "distributable net income" (secs. 652(a) and 662(a)), and the latter concept takes into account deductions of the trust which may be chargeable to capital, like trustee's fees for taking care of the principal.

The principal complication under the 1954 Code arises with respect to distributions of accumulated income. This takes the place of the 65-day rule and the twelve-months' rule under the 1939 Code. Where a distribution is made from income accumulated within the preceding five years, it is taxable to the beneficiary. Secs. 665 and 666. But, if the beneficiary chooses (as he usually will), the tax payable on the accumulation distribution is determined as if the beneficiary had received it in the year it was received by the trust. Sec. 668(a). The beneficiary is given credit against his tax liability for taxes which have been paid by the trust on this accumulated income. Sec. 668(b).

There are a number of exceptions to this "five year throw-back rule." It does not apply where the distribution is less than $2,000. Nor does it apply with respect to accumulations made before the beneficiary was born, or before he reached the age of 21. It does not apply in certain cases where the distribution is made to meet emergencies of the beneficiary. It does not apply in certain cases to distributions made when the beneficiary reaches specified ages. And it does not apply at the final distribution of a trust, where the trust has been in existence for more than nine years since it last received a transfer. Sec. 665(b).

Finally, the new Code allows the beneficiary to take advantage of net operating loss carry-overs, or of capital loss carry-overs, on the termination of an estate or trust. Where, in the final years of the estate or trust, deductions exceed income, the excess may be deducted by the beneficiary. Sec. 642(h). There is thus a considerable amount of continuity between the estate or trust and the beneficiary.

In considering the provisions of the 1954 Code, careful attention should be paid to the Regulations found in secs. 1.641–1 through 1.668(b)–2 of the Income Tax Regulations.

A good understandable summary of the 1954 Code provisions is found in Stevens, "The Income Taxation of Trusts and Estates," 1955 U. of Ill.L.Forum 406. See also Fleming, "One Year of Trust Income Taxation under the 1954 Code," 33 Taxes 892 (1955); Tomlinson, "Tears Shed over the Tier System," 106 J. of Accountancy 32 (July, 1958).

INCOME TAX REGULATIONS, SECTION 1.661(c)–2

§ 1.661(c)–2. *Illustration of the provisions of section 661.* The provisions of section 661 may be illustrated by the following example:

Example. (a) Under the terms of a trust, which reports on the calendar year basis, $10,000 a year is required to be paid out of income to a designated charity. The balance of the income may, in the trustee's discretion, be accumulated or distributed to

beneficiary A. Expenses are allocable against income and the trust instrument requires a reserve for depreciation. During the taxable year 1955 the trustee contributes $10,000 to charity and in his discretion distributes $15,000 of income to A. The trust has the following items of income and expense for the taxable year 1955:

Dividends	$10,000
Partially tax-exempt interest	10,000
Fully tax-exempt interest	10,000
Rents	20,000
Rental expenses	2,000
Depreciation of rental property	3,000
Trustee's commissions	5,000

(b) The income of the trust for fiduciary accounting purposes is $40,000, computed as follows:

Dividends		$10,000
Partially tax-exempt interest		10,000
Fully tax-exempt interest		10,000
Rents		20,000
Total		50,000
Less: Rental expenses	$2,000	
Depreciation	3,000	
Trustee's commissions	5,000	10,000
Income as computed under section 643(b)		40,000

(c) The distributable net income of the trust as computed under section 643(a) is $30,000, determined as follows:

Rents			$20,000
Dividends			10,000
Partially tax-exempt interest			10,000
Fully tax-exempt interest		$10,000	
Less: Expenses allocable thereto (10,000/50,000 x $5,000)	$1,000		
Charitable contributions allocable thereto (10,000/50,000 x $10,000)	2,000	3,000	7,000
Total			47,000
Deductions:			
Rental expenses		$2,000	
Depreciation of rental property		3,000	
Trustee's commissions ($5,000 less $1,000 allocated to tax-exempt interest)		4,000	
Charitable contributions ($10,000 less $2,000 allocated to tax-exempt interest)		8,000	17,000
Distributable net income (section 643(a))			30,000

(d) The character of the amounts distributed under section 661(a), determined in accordance with the rules prescribed in §§ 1.661(b)–1 and 1.661(b)–2 is shown by the following table (for the purpose of this allocation, it is assumed that the trustee elected to allocate the trustee's commissions to rental income except for the amount required to be allocated to tax-exempt interest):

	Rental income	Taxable Dividends	Excluded Dividends	Partially tax-exempt interest	Tax-exempt interest	Total
Trust income	$20,000	$9,950	$50	$10,000	$10,000	$50,000
Less:						
Charitable contributions	4,000	2,000	..	2,000	2,000	10,000
Rental expenses	2,000	.....	..	......	......	2,000
Depreciation	3,000	.....	..	......	......	3,000
Trustee's commissions	4,000	.....	..	......	1,000	5,000
Total deductions	13,000	2,000	0	2,000	3,000	20,000
Distributable net income	7,000	7,950	50	8,000	7,000	30,000
Amounts deemed distributed under section 661(a) before applying the limitation of section 661(c)	3,500	3,975	25	4,000	3,500	15,000

In the absence of specific provisions in the trust instrument for the allocation of different classes of income, the charitable contribution is deemed to consist of a pro rata portion of the gross amount of each item of income of the trust (except dividends excluded under section 116) and the trust is deemed to have distributed to A a pro rata portion (one-half) of each item of income included in distributable net income.

(e) The taxable income of the trust is $11,375 computed as follows:

Rental income		$20,000
Dividends ($10,000 less $50 exclusion)		9,950
Partially tax-exempt interest		10,000
Gross income		39,950
Deductions:		
Rental expenses	$ 2,000	
Depreciation of rental property	3,000	
Trustee's commissions	4,000	
Charitable contributions	8,000	
Distributions to A	11,475	
Personal exemption	100	$28,575
Taxable income		11,375

In computing the taxable income of the trust no deduction is allowable for the portions of the charitable contributions deduction ($2,000) and trustee's commissions ($1,000) which are treated under section 661(b) as attributable to the tax-exempt interest excludable from gross income. Also, of the dividends of $4,000

deemed to have been distributed to A under section 661(a), $25 (25/50ths of $50) is deemed to have been distributed from the excluded dividends and is not an allowable deduction to the trust. Accordingly, the deduction allowable under section 661 is deemed to be composed of $3,500 rental income, $3,975 of dividends, and $4,000 partially tax-exempt interest. No deduction is allowable for the portion of tax-exempt interest or for the portion of the excluded dividends deemed to have been distributed to the beneficiary.

(f) The trust is entitled to the credit allowed by section 34 with respect to dividends of $5,975 ($9,950 less $3,975 distributed to A) included in gross income. Also, the trust is allowed the credit provided by section 35 with respect to partially tax-exempt interest of $6,000 ($10,000 less $4,000 deemed distributed to A) included in gross income.

(g) Dividends of $4,000 allocable to A are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion under section 116 and the dividend received credit under section 34.

Problems

(A) Suppose the trustee makes payments which are chargeable to principal. He may (a) pay income tax on a capital gain, or (b) pay trustee fees for his services. Under the applicable state law these do not reduce the income payable to the life beneficiary. For a concrete example, suppose that the trustee receives $1,000 in dividends, and pays out $6 for a safe deposit box, and $25 for trustee's commissions with respect to principal. The $6 is chargeable to the income beneficiary, and the trustee pays him $994. What is the amount of the trustee's deduction for income distributed to the beneficiary? How much must the beneficiary include in his return? See secs. 643 ("distributable net income" equals taxable income, with certain adjustments, and taxable income, under sec. 63 means gross income minus deductions), 651(b), and 652(a) of the 1954 Code.

(B) Suppose a trust, with the income distributable, sustains a capital loss, which is chargeable against principal. To be specific, the trust has dividends of $1,000, and sustains a loss on sale of trust securities in the amount of $500. The trustee distributed $1,000 to the life beneficiary. Is the loss effectively deductible. See *Anderson v. Wilson,* 289 U.S. 20 (1933), and sec. 643(a)(3) of the 1954 Code.[1]

(C) Suppose a trust has capital gain, from the sale of trust assets, and this is not distributable to the life beneficiary under the applicable state law. In such a case, sec. 651 may be applicable, since the capital gain is not "income" as defined in sec. 643 (b). How is the capital gain taxed under the statute?

[1] For discussions under the pre-1954 law, see Murphy, "Fiduciary Gains and Losses—An Income Tax Chameleon," 6 Tax L.Rev. 85 (1950); Schneck, "The Estate's Income Tax," 20 Taxes 447 (1951).

(D) For a discussion of the problems which arise when real property is left to a trustee with directions that a person, usually the testator's widow, may use the premises free of rent, see Sterling and Midler, "Taxable Incidence of Rent-free Occupancy," 34 Taxes 759 (1956).

Notes

Johnston v. Helvering, 141 F.2d 208 (C.C.A.2d, 1943), cert. den., 323 U.S. 715 (1944), involved a salvage operation by a trustee during the depression years. The trustee invested in a mortgage. The mortgagor defaulted and interest was not paid for several years. The trustee foreclosed and took over the mortgaged property. Eventually he sold the property. In accordance with the applicable state law, he paid a portion of the proceeds to the life beneficiary to make up for the income which the beneficiary had not received while the mortgage was in default. (This is what in Trusts law is known as "allocation on delayed conversion.") Although the trust had a loss, and no income which it could distribute, the court held that the amount paid to the beneficiary was taxable as income to it, since it was on account of the beneficiary's claim for income.

Under the 1954 Code, the beneficiary would not be subject to tax in such a case, since the amount taxable to the beneficiary cannot exceed the distributable net income of the trust. See secs. 652(b) and 662(a)(2).

Suppose the trustee of a trust receives a dividend of common stock on common stock held by the trust, which, under the tax law, is not taxable income. By the state law, however, he is required to distribute the dividend stock to the life beneficiary, which he does. Is the distribution taxable as income to the beneficiary? See, generally, Stevens, "Tax Aspects of Estate Distributions," 35 Taxes 970 (1957).

Other Problems

(A) In some cases income is received under circumstances where its ownership is unknown. Suppose, for example, that a person finds a bearer government bond with coupons attached. A coupon becomes due. Is the income taxable? To whom? For a discussion of related questions, see Moore and Sorlien, "Homeless Income," 8 Tax L.Rev. 425 (1953).

(B) In *United States v. Higginson,* 238 F.2d 439 (C.A.1st, 1956), it appeared that the taxpayers were trustees of a trust under which they were directed to make semiannual distributions of the net income of the trust to designated beneficiaries. There were further rather elaborate provisions in the trust instrument. In 1948, the trustees were notified by counsel for certain residuary beneficiaries of the estate of the testator who created the trust that they contended that the life estates and remainder under the will were invalid as violative of the Rule Against Perpetuities. The trustees then, on advice of their counsel, decided to withhold any further distributions, and this was done from 1948 through 1950. In 1951, the Massachusetts courts held that the trust did not violate the Rule Against Perpetuities, and shortly thereafter the retained income was distributed to the beneficiaries.

The Court of Appeals for the First Circuit held that the income of this trust was, throughout the period when income was withheld, "distributable" to the beneficiaries, and, consequently, deductible by the trustees on their fiduciary return. The court said that "Failure of the trustees to recognize the designated beneficiaries' present rights to receive the income neither altered these rights of property nor affected the incidence of tax as to the beneficiaries." In reaching its result, the court refused to follow an administrative ruling, I.T. 1733, II–2 Cum.Bull. 169 (1923).

(C) Do the provisions of the 1954 Code in secs. 641–668 have any application to legal interests? Suppose for example that Blackacre is devised to A for life, with remainder to B. The Government takes Blackacre by eminent domain and pays A its fair market value, which is in excess of A's basis for the land. There is a capital gain. To whom is it taxable? One court held it was not taxable to anyone under the present law. *United States v. Cooke,* 228 F.2d 667 (C.A.9th, 1955), noted in 56 Col.L. Rev. 947 (1956), and in 51 Northwestern U.L.Rev. 487 (1956). The district court's decision is noted in 67 Harv.L.Rev. 1083 (1954). But more recently, The Ninth Circuit has overruled the *Cooke* case (*Commissioner v. de Bonchamps,* —— F.2d —— (C.A.9th, 1960)), and another court has held that the life tenant is a fiduciary, and must report the gain on a fiduciary return. *Weil v. United States,* 180 F.Supp. 407 (Ct.Cl. 1960). Such is the way of the tax law!

Multiple Trusts

If the income is taxable to the trust, it may make a difference whether there is one trust for several beneficiaries, or several trusts, one for each beneficiary. In *United States Trust Co. v. Commissioner,* 296 U.S. 481 (1936), the Court held that it was a question of fact in each case whether one trust or several trusts were created. The Court also held that the trust property of each separate trust might be an undivided interest in the property left by the will. Note the deduction for personal exemption allowed to trusts and estates by sec. 642(b) of the 1954 Code.

Note the special provision for "substantially separate and independent shares of different beneficiaries in the trust" in sec. 663(c) of the 1954 Code.

On the general question, see "Multiple Trusts and the Minimization of Federal Taxes," 40 Col.L.Rev. 309 (1940); Tremper, "Single v. Multiple Trusts," 17 Taxes 463 (1939). The problem of multiple trusts was discussed in the Hearings Before the Joint Committee on Tax Evasion and Avoidance, 75 Cong., 1st Sess. 262–287 (1937), where one case was disclosed in which 64 trusts had been created for the benefit of four members of an immediate family. See Paul, "The Background of the Revenue Act of 1937," 5 U. of Chi.L.Rev. 41, 71–76 (1937).

For recent discussions, see Ervin, "Multiple Accumulative Trusts and Related Problems under the Income Tax," 29 So.Calif. L.Rev. 402 (1956); "Taxation of Multiple Trusts," 24 U. of Chi. L.Rev. 156 (1956); Gordon, "Multiple Trusts: The Consolidation Approach," 4 Wayne L.Rev. 25 (1957).

Estates

For the consideration of further problems, see North, "Income Tax Consequences in the Administration of Decedents' Estates," 39 Neb.L.Rev. 273 (1960); Bowe, "Income Tax Problems of Executors and Administrators," 32 Rocky Mountain L. Rev. 42 (1959); Baker, "Income Tax Planning for Executors," 9 Tax L.Rev. 281 (1954).

1960 Amendments

A substantial revision of the provisions relating to Trusts was pending before Congress in the summer of 1960, but was not enacted in time for inclusion in this book. If enacted, it will be covered by Supplements to be issued from time to time.

C. FAMILY PARTNERSHIPS

COMMISSIONER v. CULBERTSON

Supreme Court of the United States, 1949. 337 U.S. 733

MR. CHIEF JUSTICE VINSON delivered the opinion of the Court.

This case requires our further consideration of the family partnership problem. The Commissioner of Internal Revenue ruled that the entire income from a partnership allegedly entered into by respondent and his four sons must be taxed to respondent, and the Tax Court sustained that determination. The Court of Appeals for the Fifth Circuit reversed. 168 F.2d 979. We granted certiorari, 335 U.S. 883, to consider the Commissioner's claim that the principles of *Commissioner v. Tower,* 327 U.S. 280 (1946), and *Lusthaus v. Commissioner,* 327 U.S. 293 (1946), have been departed from in this and other courts of appeals decisions.

Respondent taxpayer is a rancher. From 1915 until October 1939, he had operated a cattle business in partnership with R. S. Coon. Coon, who had numerous business interests in the Southwest and had largely financed the partnership, was 79 years old in 1939 and desired to dissolve the partnership because of ill health. To that end, the bulk of the partnership herd was sold until, in October of that year, only about 1,500 head remained. These cattle were all registered Herefords, the brood or foundation herd. Culbertson wished to keep these cattle and approached Coon with an offer of $65 a head. Coon agreed to sell at that price, but only upon condition that Culbertson would sell an undivided one-half interest in the herd to his four sons at the same price. His reasons for imposing this condition were his intense interest in maintaining the Hereford strain which he and Culbertson had developed, his conviction that Culbertson was too old to

carry on the work alone, and his personal interest in the Culbertson boys. Culbertson's sons were enthusiastic about the proposition, so respondent thereupon bought the remaining cattle from the Coon and Culbertson partnership for $99,440. Two days later Culbertson sold an undivided one-half interest to the four boys, and the following day they gave their father a note for $49,720 at 4 per cent interest due one year from date. Several months later a new note for $57,674 was executed by the boys to replace the earlier note. The increase in amount covered the purchase by Culbertson and his sons of other properties formerly owned by Coon and Culbertson. This note was paid by the boys in the following manner:

Credit for overcharge	$ 5,930
Gifts from respondent	21,744
One-half of a loan procured by Culbertson & Sons partnership	30,000

The loan was repaid from the proceeds from operation of the ranch.

The partnership agreement between taxpayer and his sons was oral. The local paper announced the dissolution of the Coon and Culbertson partnership and the continuation of the business by respondent and his boys, under the name of Culbertson & Sons. A bank account was opened in this name, upon which taxpayer, his four sons and a bookkeeper could check. At the time of formation of the new partnership, Culbertson's oldest son was 24 years old, married, and living on the ranch, of which he had for two years been foreman under the Coon and Culbertson partnership. He was a college graduate and received $100 a month plus board and lodging for himself and his wife both before and after formation of Culbertson & Sons and until entering the Army. The second son was 22 years old, was married and finished college in 1940, the first year during which the new partnership operated. He went directly into the Army following graduation and rendered no services to the partnership. The two younger sons, who were 18 and 16 years old respectively in 1940, went to school during the winter and worked on the ranch during the summer.[1]

The tax years here involved are 1940 and 1941. A partnership return was filed for both years indicating a division of income approximating the capital attributed to each partner. It is the disallowance of this division of the income from the ranch that brings this case into the courts.

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1 A daughter was also made a member of the partnership some time after its formation upon the gift by respondent of one-quarter of his one-half interest in the partnership. Respondent did not contend before the Tax Court that she was a partner for tax purposes.

First. The Tax Court read our decisions in *Commissioner v. Tower, supra,* and *Lusthaus v. Commissioner, supra,* as setting out two essential tests of partnership for income-tax purposes: that each partner contribute to the partnership either vital services or capital originating with him. Its decision was based upon ~~a finding that~~ none of respondent's sons had satisfied those requirements during the tax years in question. Sanction for the use of these "tests" of partnership is sought in this paragraph from our opinion in the *Tower* case:

> "There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other, purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital services, or does all of these things she may be a partner as contemplated by 26 U.S.C. Secs. 181, 182. The Tax Court has recognized that under such circumstances the income belongs to the wife. A wife may become a general or a limited partner with her husband. But when she does not share in the management and control of the business, contributes no vital additional service, and where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into consideration in determining whether the partnership is real within the meaning of the federal revenue laws." 327 U.S. at 290.

It is the Commissioner's contention that the Tax Court's decision can and should be reinstated upon the mere reaffirmation of the quoted paragraph.

The Court of Appeals, on the other hand, was of the opinion that a family partnership entered into without thought of tax avoidance should be given recognition tax-wise whether or not it was intended that some of the partners contribute either capital or services during the tax year and whether or not they actually made such contributions, since it was formed "with the full expectation and purpose that the boys would, in the future, contribute their time and services to the partnership."[2] We must consider, therefore, whether an intention to contribute capital or services sometime in the future is sufficient to satisfy ordinary concepts of partnership, as required by the *Tower* case. The sections of the Internal Revenue Code involved are

[2] 168 F.2d 979 at 982. The court further said: "Neither statute, common sense, nor impelling precedent requires the holding that a partner must contribute capital or render services to the partnership prior to the time that he is taken into it. These tests are equally effective whether the capital and the services are presently contributed or are later to be contributed or to be rendered." *Id.* at 983. See Note, 47 Mich.L.Rev. 595.

§§ 181 and 182, which set out the method of taxing partnership income, and §§ 11 and 22(a), which relate to the taxation of individual incomes.

In the *Tower* case we held that despite the claimed partnership, the evidence fully justified the Tax Court's holding that the husband, through his ownership of the capital and his management of the business, actually created the right to receive and enjoy the benefit of the income and was thus taxable upon that entire income under §§ 11 and 22(a). In such case, other members of the partnership cannot be considered "Individuals carrying on business in partnership" and thus "liable for income tax . . . in their individual capacity" within the meaning of § 181. If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years in question, as the Court of Appeals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years.[3] The partnership sections of the Code are, of course, geared to the sections relating to taxation of individual income, since no tax is imposed upon partnership income as such. To hold that "Individuals carrying on business in partnership" include persons who contribute nothing during the tax period would violate the first principle of income taxation: that income must be taxed to him who earns it. *Lucas v. Earl,* 281 U.S. 111 (1930); *Helvering v. Clifford,* 309 U.S. 331 (1940); *National Carbide Corp. v. Commissioner,* 336 U.S. 422 (1949).

Furthermore, our decision in *Commissioner v. Tower, supra,* clearly indicates the importance of participation in the business by the partners during the tax year. We there said that a partnership is created "when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and where there is community of interest in the profits and losses." This is, after all, but the application of an often iterated definition of income—the gain derived from capital, from labor, or from both combined—to a particular form of business organization. A partnership is, in other words, an organization for the production of income to which each partner contributes one or both of the ingredients of income—capital or services. *Ward v. Thompson,* 22 How. 330, 334 (1859). The intent to provide money, goods, labor, or skill sometime in the future cannot meet the demands of §§ 11 and 22(a) of the Code that he who presently earns the income through his own

[3] Of course one who has been a bona fide partner does not lose that status when he is called into military or government service, and the Commissioner has not so contended. On the other hand, one hardly becomes a partner in the conventional sense merely because he might have done so had he not been called.

labor and skill and the utilization of his own capital be taxed therefor. The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income.[4]

Second. We turn next to a consideration of the Tax Court's approach to the family partnership problem. It treated as essential to membership in a family partnership for tax purposes the contribution of either "vital services" or "original capital." Use of these "tests" of partnership indicates, at best, an error in emphasis. It ignores what we said is the ultimate question for decision, namely, "whether the partnership is real within the meaning of the federal revenue laws" and makes decisive what we described as "circumstances [to be taken] into consideration" in making that determination.[5]

The *Tower* case thus provides no support for such an approach. We there said that the question whether the family partnership is real for income-tax purposes depends upon

> "whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits or losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.' *Drennen v. London Assurance Co.*, 113 U.S. 51, 56; *Cox v. Hickman*, 8 H.L.Cas. 268. We see no reason why this general rule should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes." 327 U.S. at 287.

The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. There is nothing new or particularly difficult about such a test. Triers of fact are con-

[4] The *reductio ad absurdum* of the theory that children may be partners with their parents before they are capable of being entrusted with the disposition of partnership funds or of contributing substantial services occurred in Tinkoff v. Commissioner, 120 F.2d 564, where a taxpayer made his son a partner in his accounting firm the day the son was born.

[5] See Mannheimer and Mook. A Taxwise Evaluation of Family Partnerships, 32 Iowa L.Rev. 436, 447–48.

stantly called upon to determine the intent with which a person acted. The Tax Court, for example, must make such a determination in every estate tax case in which it is contended that a transfer was made in contemplation of death, for "The question, necessarily, is as to the state of mind of the donor." *United States v. Wells,* 283 U.S. 102, 117 (1931). See *Allen v. Trust Co. of Georgia,* 326 U.S. 630 (1946). Whether the parties really intended to carry on business as partners is not, we think, any more difficult of determination or the manifestations of such intent any less perceptible than is ordinarily true of inquiries into the subjective.

But the Tax Court did not view the question as one concerning the bona fide intent of the parties to join together as partners. Not once in its opinion is there even an oblique reference to any lack of intent on the part of respondent and his sons to combine their capital and services "for the purpose of carrying on the business." Instead, the court, focusing entirely upon concepts of "vital services" and "original capital," simply decided that the alleged partners had not satisfied those tests when the facts were compared with those in the *Tower* case. The court's opinion is replete with such statements as "we discern nothing constituting what we think is a requisite contribution to a real partnership. . . . We find no son adding 'vital additional service' which would take the place of capital contributed because of formation of a partnership . . . it is clear that the sons made no capital contribution within the meaning of the *Tower* case." [6]

Unquestionably a court's determination that the services contributed by a partner are not "vital" and that he has not participated in "management and control of the business" or contributed "original capital" has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners. But such a determination is not conclusive, and that is the vice in the "tests" adopted by the Tax Court. It assumes that there is no room for an honest difference of opinion as to whether the services or capital furnished by the alleged partner are of sufficient importance to justify his inclusion in the partnership. If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that

[6] In the Tower case the taxpayer argued that he had a right to reduce his taxes by any legal means, to which this Court agreed. We said, however, that existence of a tax avoidance motive gives some indication that there was no bona fide intent to carry on business as a partnership. If Tower had set up objective requirements of membership in a family partnership, such as "vital services" and "original capital," the motives behind adoption of the partnership form would have been irrelevant.

is sufficient. The *Tower* case did not purport to authorize the Tax Court to substitute its judgment for that of the parties; it simply furnished some guides to the determination of their true intent. Even though it was admitted in the *Tower* case that the wife contributed no original capital, management of the business, or other vital services, this Court did not say as a matter of law that there was no valid partnership. We said, instead, that "There was, thus, more than ample evidence to support the Tax Court's finding that no genuine union for partnership purposes *was ever intended* and that the husband earned the income." 327 U.S. at 292. (Italics added.)

Third. The Tax Court's isolation of "original capital" as an essential of membership in a family partnership also indicates an erroneous reading of the *Tower* opinion. We did not say that the donee of an intra-family gift could never become a partner through investment of the capital in the family partnership, any more than we said that all family trusts are invalid for tax purposes in *Helvering v. Clifford, supra.* The facts may indicate, on the contrary, that the amount thus contributed and the income therefrom should be considered the property of the donee for tax, as well as general law, purposes. In the *Tower* and *Lusthaus* cases this Court, applying the principles of *Lucas v. Earl, supra, Helvering v. Clifford, supra,* and *Helvering v. Horst, supra,* found that the purported gift, whether or not technically complete, had made no substantial change in the economic relation of members of the family to the income. In each case the husband continued to manage and control the business as before, and income from the property given to the wife and invested by her in the partnership continued to be used in the business or expended for family purposes. We characterized the results of the transactions entered into between husband and wife as "a mere paper reallocation among the family members," noting that "The actualities of their relation to the income did not change." This, we thought, provided ample grounds for the finding that no true partnership was intended; that the husband was still the true earner of the income.

But application of the *Clifford-Horst* principle does not follow automatically upon a gift to a member of one's family, followed by its investment in the family partnership. If it did, it would be necessary to define "family" and to set precise limits of membership therein. We have not done so for the obvious reason that existence of the family relationship does not create a status which itself determines tax questions,[7] but is simply a warning that things may not be what they seem. It is frequently stated that transactions between members of a family will be carefully scru-

[7] Except, of course, when Congress defines "family" and attaches tax consequences thereto. See, e. g. 26 U.S.C. § 503(a)(2).

tinized. But more particularly, the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used. He is able in other words, to retain "the substance of full enjoyment of all the rights which previously he had in the property." *Helvering v. Clifford, supra,* at 336.

The fact that transfers to members of the family group may be mere camouflage does not, however, mean that they invariably are. The *Tower* case recognized that one's participation in control and management of the business is a circumstance indicating an intent to be a bona fide partner despite the fact that the capital contributed originated elsewhere in the family. If the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise. In the *Tower* and *Lusthaus* cases we distinguished between active participation in the affairs of the business by a donee of a share in the partnership on the one hand, and his passive acquiescence to the will of the donor on the other.[8] This distinction is of obvious importance to a determination of the true intent of the parties. It is meaningless if "original capital" is an essential test of membership in a family partnership.

The cause must therefore be remanded to the Tax Court for a decision as to which, if any, of respondent's sons were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners, as we have defined that term in the *Clifford, Horst,* and *Tower* cases? No question as to the allocation of income between capital and services is presented in this case, and we intimate no opinion on that subject.

The decision of the Court of Appeals is reversed with directions to remand the cause to the Tax Court for further proceedings in conformity with this opinion.

Reversed and remanded.

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[8] There is testimony in the record as to the participation by respondent's sons in the management of the ranch. Since such evidence did not fall within either of the "tests" adopted by the Tax Court, it failed to consider this testimony. Without intimating any opinion as to its probative value, we think that it is clearly relevant evidence of the intent to carry on business as partners.

MR. JUSTICE BLACK and MR. JUSTICE RUTLEDGE think that the Tax Court properly applied the principles of the *Tower* and *Lusthaus* decisions (327 U.S. 280, *id.*, 293) in this case. However, they consider it of paramount importance in this case to have a court interpretation of the applicable taxing statute, for guidance in its application. Accordingly, they acquiesce in the Court's opinion and judgment.

MR. JUSTICE BURTON, concurring, states that, upon remand of the cause to the Tax Court, there is nothing in the facts which have been presented here which, as a matter of law, will preclude that court from finding that the 1940 and 1941 income was properly taxable on a partnership basis. The physical absence of some of the Culbertson boys from the ranch does not necessarily preclude them or others from the obligations or the benefits of the partnership for tax purposes. Their contributions of capital, their participation in the income and their commitments to return to the ranch or otherwise to render service to the partnership are among the material factors to be considered. A present commitment to render future services to a partnership is in itself a material consideration to be weighed with all other material considerations for the purposes of taxation as well as for other partnership purposes.

MR. JUSTICE JACKSON would affirm on the opinion of the court below, being of the view that the ordinary common-law tests of validity of partnerships are the tests for tax purposes and that they were met in this case.

A concurring opinion by MR. JUSTICE FRANKFURTER is omitted. He said: "I think, however, that it is due to the Tax Court, the Courts of Appeals, the Treasury and the bar to make more explicit what the appropriate legal criteria are."

Notes

(A) Discussions of the problem in the light of the *Culbertson* case include Bruton, "Family Partnerships and the Income Tax: The Culbertson Chapter," 98 U. of Pa.L.Rev. 143 (1949). See also, on the general problem of taxing partnership income, apart from family factors, Brookes, "The Strange Nature of the Partnership under the Income Tax Law," 5 Tax L.Rev. 35 (1949).

(B) Even though a family partnership is not recognized for federal tax purposes, its members are "related taxpayers" within the meaning of sec. 1313(c)(6) of the 1954 Code if the partnership is valid under state law. I.T. 3986, 1949–2 Cum.Bull. 108. This provides a means of unravelling federal tax liabilities where a partnership is not effective for tax purposes.

Sec. 704(e) of the 1954 Code

This question is now much affected by the provisions found in sec. 704(e) of the 1954 Code. See sec. 1.704–1(e) of the Income Tax Regulations. This section had its origin in amendments made by Congress in 1951. One of these amended the definition of a partner in section 3797(a)(2) of the 1939 Code. The effect of the amendment was to recognize, for tax purposes, a partnership in which the partner owns a capital interest whether or not that interest was acquired by purchase or gift from any other person, including a member of the family.

The other 1951 amendment added a new section 191 to the 1939 Code, dealing expressly with family partnerships. This carried out the other provision, and had the effect of requiring the recognition of "family partnerships." It provided, however, that the distributive share of a partner may not be "determined without allowance of reasonable compensation for services rendered to the partnership by the donor." Both of these provisions are now in sec. 704(e) of the 1954 Code.

For a discussion of the 1951 version of these provisions, see "Family Partnerships and the Revenue Act of 1951," 61 Yale L.J. 541 (1952). See also Lifton, "The Family Partnership: Here We Go Again," 7 Tax L.Rev. 461 (1952); Schulman, "Current Tests for Valid Family Partnership Arrangements," 31 Taxes 447 (1953).

For a complete discussion see Chaper 29 (pages 425–451) of Willis, Handbook of Partnership Taxation (1957).

Problem

What questions are these provisions likely to raise? Does it seem likely that the present statutory solution will eliminate further controversy in the family partnership area? Is the new provision desirable or justifiable? Is there any reason why gifts of property in the form of interests in a family partnership should not be effective for tax purposes to the same extent that gifts of other sorts of property are effective?

WOFFORD v. COMMISSIONER

Court of Appeals, Fifth Circuit, 1953. 207 F.2d 749.

HUTCHESON, CIRCUIT JUDGE. . . . The taxpayer's petition presents two substantial questions for our decision. One of these is whether the Tax Court erred in holding and deciding that the petitioner and his wife as trustees for their minor daughter were not members of the partnership which in the fiscal years, 1942, 1943, and 1944, operated the Tatem Hotel property. The other is whether if it did not err in so holding, it did err in

taxing to petitioner and his wife the whole of the net income received from the operation of the hotel instead of allocating to the trust either the one-third of the income from the operation of the hotel which petitioner and his wife individually and as trustees had agreed should be, and which had been, allocated to it, or such an amount less than that as the Tax Court determined was attributable to the trust as earned by it, based upon the value of the use or rental value of the trust's one-third interest.

. . .

The matters presented for our decision come up in this way: The Commissioner, rejecting the claims made in the individual returns of taxpayer and his wife and their returns as trustees, that during the years in question taxpayer and his wife as trustees were in partnership in the conduct of the hotel business conducted under the name of Tatem, determined: that all of the income was earned by petitioner; and that, instead of being taxed one-third to petitioner, one-third to his wife, and one-third to the trust, the whole of the net income should be taxed to him.

. . .

In his petition and amended petition filed in the Tax Court, in addition to attacking as erroneous the Commissioner's determination (a) that petitioner and his wife were not in partnership, and (b) that petitioner and his wife and petitioner and his wife as trustees were not in partnership, petitioner assigned as error (1) the determination of the Commissioner that the net income of the hotel business was taxable in full to the petitioner and (2) his failure to determine that petitioner and Patrica Wofford and the Margaret Wofford Trust, as joint owners, were each taxable on one-third of the income from the operation of the hotel.

The facts came in without dispute, and the Tax Court's holding and decision that petitioner and his wife individually constituted the partnership and that he and his wife as trustees were not members of it, as well as its ruling and decision that petitioner and his wife must be taxed with all the income from the property without allocation of any of it to them as trustees was not based upon a resolution of conflicting evidence but upon the determination of the effect of undisputed evidence.[1]

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[1] This showed, and the Tax Court found, that the taxpayer and his then wife, Patrica Wofford, built the Tatem Hotel in Miami Beach in 1938, with joint funds, and thereafter until Dec. 31, 1941, operated the hotel as partners. On that date the taxpayer and his wife created a trust for their daughter, then 12 years of age, by warranty deed conveying to themselves as trustees an undivided one-third interest in the real estate situated in the city of Miami Beach, the land and building on and in which the Tatem Hotel operations were conducted. Simultaneously they executed a written declaration of trust declaring that they had received and were holding the property so

Examining the findings of the Tax Court in the light of this record, as they relate to the contentions of the taxpayer, we think it clear that it cannot be said of the Tax Court's finding against petitioner's first claim, that the trust was a member of the Tatem Hotel partnership, that it was clearly erroneous and must be set aside. Cf. *Alexander v. Commissioner*, 5 Cir., 194 F.2d 923.

When it comes, however, to petitioner's second contention, that the Tax Court erred in taxing the whole of the net income to petitioner and his wife instead of taxing to the trust such part of it as was properly attributable to the one-third interest in the properties owned by the trust, we think its holding and decision was without support in the evidence, indeed was directly contrary to it. For whether the income from the operation of the property properly taxable to the petitioner and his wife should be ascertained by allocating to the interest of the trust in the property a portion of the income as income, the fruits of its interest in the property, and therefore, attributable to it as income, or should be ascertained by allowing to the trust the value of the use of the property, that is its rental value, with a corresponding credit to the petitioners from that allowance, is immaterial. In substance the result would be the same, and taxation goes by substance and not by shadow.

In a similar situation and upon evidence far less compelling than that presented here, we have recognized and given effect to income allocations to the interest in property which created the income. Of the many cases where we have done this, it is sufficient to cite: *Greenspun v. Commissioner*, 5 Cir., 156 F.2d 917;

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conveyed as trustees for their daughter as beneficiary. The deed and declaration of trust were duly recorded.

The trust instrument provided that the trustees were to receive and collect the principal and income from the estate and they were to pay or accumulate, use, invest, hold, apply and distribute the same for, or for the use of, the beneficiary. The declaration of trust further provided that the entire net income received from the trust estate "as it represents an undivided one-third interest in an operating business and as such may not be available for distribution" should be used, first for payment of the indebtedness encumbering the trust estate and to be accumulated for subsequent distribution to the daughter. The trust was to continue until the beneficiary should obtain the age of thirty years.

While there are some discrepancies and contradictions in the terms of the trust, it is sufficient to say of it that, as was found by the Circuit Court of Dade County, pursuant to a petition filed by petitioner and his wife individually and as trustee for the minor beneficiary, the warranty deed of Dec. 31, 1941, was in effect a conveyance of the beneficial interest to themselves as trustees of an undivided one-third interest in the real estate. This construction necessarily followed from the declaration in the trust instrument that the beneficiary had interest in the earnings, avails, and proceeds and the other statement that the income to be recovered by the trust represents an undivided one-third interest in an operating business. While the books and records of the business and the income tax returns showed that one-third of the income from the operation of the hotel was attributed to the Trust, there was no proof of any formal or definite agreement that the trust was a partner, indeed except as it might be inferred from the allocation of the income between the three interests, there was no evidence that it was a partner.

Simmons v. Commissioner, 5 Cir., 164 F.2d 220; *Henson v. Commissioner*, 5 Cir., 174 F.2d 846; *Alexander v. Commissioner*, 5 Cir., 190 F.2d 953; *Phillips v. United States*, 5 Cir., 193 F.2d 132, and *Alexander v. Commissioner*, 5 Cir., 194 F.2d 921. . . .

Here, from the very beginning the parties, in dealing with the value of the use of the hotel property, had agreed and acted upon the agreement that the income value of the interest contributed by the trust was one-third of the net profits, and the books were kept and income tax returns made throughout on that basis. The very fact that there was no written or otherwise definite agreement, as found by the Tax Court, that the trust should be a partner with the usual incidents of a partnership, a sharing of the profits and of the losses, makes it clear, we think, that the parties at all times understood that the value of the contribution made by the trust to the income bearing venture would be one-third of the net income, and that they were not particularly concerned beyond that basic agreement in the details of it.

These facts plus the undisputed fact that the trust contributed to the venture the use of its one-third interest, while, in view of the Tax Court holding, not sufficient to establish a partnership, were ample as a basis for a finding as to the value in terms of income of the contribution the trust made. There was, therefore, evidence upon which the Tax Court could have allotted to the trust the interest in the income which the parties had agreed to give it. Whether this should be called rent, or the value of the use, it was certainly the measure of what the parties had agreed would entitle it to one-third of the net income.

This is not to say that the Tax Court was compelled to accept their agreement, as to the value of the use or rental value if, under all the facts of record, the agreed amount was excessive. Cf. *Greenspun v. Commissioner*, supra. It is to say, though, that upon the rejection by the Tax Court of the claim of partnership, it was incumbent upon it to determine the value to the business of the use of the one-third interest owned by the trust and upon this basis reallocate the income attributed to petitioner by giving full effect to that determination. . . .

The decision and order of the Tax Court denying petitioner's alternative claim to relief [is] reversed and the cause is remanded to the Tax Court for further and not inconsistent proceedings. . .

Family Corporations

Will a gift of corporate stock always be effective for tax purposes, even though the shareholder makes no contribution of capital or services to the business? Does the *Culbertson* case mean that such a gift, if real, that is, if it actually makes the

donee a shareholder in his own right, will always make the dividends taxable to the shareholder? Is this a means by which the income from the personal activities of those managing the business may be diverted to others? See Alexandre, "The Corporate Counterpart of the Family Partnership," 2 Tax L.Rev. 493 (1947); Mannheimer, "Income Tax Status of Gifts of Family Corporation Stock," 25 Taxes 604 (1947).

See *Overton v. Commissioner,* 6 T.C. 304 (1946), where A and B owned all the stock of a corporation. They caused the corporation to issue new class B stock. This stock was entitled to receive dividends in the discretion of the board of directors after the old stock had received dividends at the rate of $10 a share each year. The class B stock was entitled to $1 per share on dissolution, all other assets being payable to the old common stock. All voting rights were in the old common stock. Shortly after the issue of the class B stock, A and B gave it to their wives, who thereafter received dividends on it. About a year later the wives entered into an agreement not to sell their shares without the consent of other stockholders. The wives received dividends on the class B shares. Were the dividends taxable to A and B? Were A and B subject to a gift tax liability with respect to them?

D. OTHER FAMILY ARRANGEMENTS

WHITE v. FITZPATRICK

United States Court of Appeals, Second Circuit, 1951. 193 F.2d 398.
Certiorari denied 343 U.S. 928 (1952).

CLARK, CIRCUIT JUDGE. Involved in this appeal is the recurring problem of tax savings claimed as a consequence of a transfer of property from husband to wife with resulting lease or license back. Here neither the Commissioner of Internal Revenue nor the district court has accepted the taxpayer's view of the transactions; and he now appeals from the judgment against him in his action for a refund of the deficiency assessed against him by the Commissioner upon his income and victory taxes for the years 1941, 1943, and 1944.

The following are the facts of the case as stipulated by the parties and found by the trial court. During the years in question and for some time prior thereto, plaintiff engaged in the manufacture of chokes for use on the barrels of shotguns, as sole proprietor of the Poly Choke Company, an unincorporated business. Beginning in 1939 the company occupied certain properties—land, three factories, a garage, and an office—under a lease coupled with a nontransferable option to purchase for $15,370. Plaintiff had developed the basic invention for this device himself and obtained a United States patent for it on December 27, 1932.

On January 21, 1941, he entered into a written agreement with his wife, transferring "the entire right, title and interest in and to" the patent, "to the full end of the term of said patent," for a

stated consideration of $10. The following day his wife licensed the exclusive manufacturing right back to him "to the full end of the entire term of said patent." The assignment back was subject to cancellation only if (a) payments fell into sixty days' arrears, or (b) receivership, bankruptcy, forced assignment, or other financial difficulty made it impossible for her husband to carry on his manufacturing concern. It provided for royalties of $1 on each product marketed. Plaintiff filed a gift tax return for the year declaring the fair market value of the patent to be $10,000 and for the next four years, 1941–1944 inclusive, paid his wife some $60,000 as royalties.

At about the same time, December 27, 1940, plaintiff's wife also purchased the property on which the company was located for $16,800 and immediately leased it to her husband orally. On the next day plaintiff made a gift to his wife of $16,175 to cover the purchase price and filed a gift tax return for that amount. Rental payments for the years 1941–1944 inclusive were $1,500 a year, which was the amount that plaintiff had been paying to the original lessor; in 1944, plaintiff in addition paid his wife some $5,000 as "an adjustment in rent."

During the years in question plaintiff deducted both rental payments and royalties as business expenses. After investigation and audit, the Commissioner of Internal Revenue issued a deficiency notice disallowing the deductions in 1948. Plaintiff paid the total deficiency of about $47,000 thus assessed and brought this action for refund. The district court found (1) that the plaintiff's motivation was to make good certain losses in the value of securities held by his wife and to minimize income taxes for the family group, but (2) that "it was the taxpayer's expectation that no action would be taken by the wife in exercise of her rights of ownership of the patent or real property which would be detrimental to the plaintiff's interests." The court then concluded that by the gifts and license and lease back "by reason of the family relationship the husband retains effective control of the patent and real property, while valid transfers for other purposes, will not form a valid basis for deduction of royalties and rent paid by the husband to the wife as business expenses in arriving at the taxpayer's net income for income tax purposes."

The bare assignment of the patent was legally adequate to transfer all rights adhering thereto to the wife. Likewise the land was purchased in the name of the wife alone. From this plaintiff contends on appeal that the wife's legal title and power were absolute and subject to no conditions or future claims whatsoever. Moreover, there is no evidence, nor does defendant contend, that the plaintiff derived any direct benefit in the form of income from these transactions. Therefore, plaintiff argues that, since the royalties and rents were both ordinary in nature for his type of busi-

ness and reasonable in amount, they constitute valid business expenses under I.R.C. § 23(a)(1)(A), which authorizes the deduction from gross income of "ordinary and necessary expenses" paid "in carrying on any trade or business." See *Welch v. Helvering*, 290 U.S. 111; *Deputy v. duPont*, 308 U.S. 488.

Underlying reality, however, contradicts this appearance of a complete assignment. "Title" to the patent and land may legally reside in the plaintiff's wife; practically and actually, as the district court concluded, control rests with the husband as effectively as if he had never made the gift of the patent to his wife or given her the money with which to buy the property. Assignment and gift cannot be divorced for tax purposes from their accompanying agreements whereby the husband retained dominion. And in fact plaintiff never intended that it should be; he admitted the impossibility of conducting the business without this basic patent or of finding a comparable factory site in Connecticut. His wife was neither equipped nor evinced any desire to exercise or transfer any rights to the use of either of the properties; in the case of the patent at least, it is clear that she had no legal right to do so, save in the unlikely event of the husband's default. The sole practical effect of these transactions, therefore, was to create a right to income in the wife, while leaving untouched in all practical reality the husband-donor's effective dominion and control over the properties in question. It is not without significance on this point that the arrangement made was actually disadvantageous to the business. For it passed over the reduction of land charges which the taxpayer might have made by taking up his option to purchase in order to create the income right in the donor's wife, and that, too, at a greater capital cost. For the statutory purposes, the mere creation of a legal obligation to pay is not controlling. *Interstate Transit Lines v. C. I. R.*, 8 Cir., 130 F.2d 136, affirmed 319 U.S. 590.

In this respect, then, the case before us does not involve the definite problem presented by the completed assignment of a created product which divided our court and the Fourth Circuit, both inter- and extra-murally, in the two cases of *Wodehouse v. C. I. R.*, 2 Cir., 177 F.2d 881, Id., 4 Cir., 178 F.2d 987. Gift and retained control must be regarded as inseparable parts of a single transaction, especially since it was only in their sum total that they had any reality in regard to the conduct of plaintiff's business. To isolate them, as would be necessary to bring them within the rationale of our own majority ruling in *Wodehouse v. C. I. R.*, supra, is to hide business reality behind paper pretense.

For the question here is as to the tax consequences of a formal gift of certain income-producing properties by the husband to his wife coupled with the informal retention of administrative control

—the transfer, in effect, of the right to receive income and the retention of those complex of "use rights" which are usually compressed in the term "ownership." In the context of I.R.C. § 23(a) (1)(A), the question is a rather new one; under I.R.C. § 22(a), where it arises in the definition of gross income problems, it is not. And we think the line drawn in the precedents under the latter section is the same as that in the field of deductibility of business expenses. Plaintiff here, for example, accepts as his own the income he has received on the patent equivalent to the royalties he is paying his wife, but then seeks to deduct it as a business expense; in effect this is not different from claiming that the gift itself made the original income hers in the first place.

We think, therefore, that the principles governing the intermarital transfer of income enunciated in *Helvering v. Clifford*, 309 U.S. 331, and re-enforced by later cases, are also decisive here. In the case at bar, plaintiff assigned the "legal title" to the patent and provided for his wife's assumption of the "legal title" to the land; but he retained, by formal agreement in the first case, by informal arrangement in the second, the administrative control of these properties. His wife had the right to income, but he had a right to the use of the patent and land. *Henson v. C. I. R.*, 5 Cir., 174 F.2d 846, is thus distinguishable. The Clifford rule is clear, that this direct control, when fused with the indirect control which we must imply from a formal but unsubstantial assignment within the closed family group displaying no obvious business purpose, renders the assignment ineffective for federal tax purposes. The same result should obtain whether the question arises under § 22(a) or § 23(a)(1)(A) of the Internal Revenue Code.

Plaintiff relies heavily on *Skemp v. C. I. R.*, 7 Cir., 168 F.2d 598, and *Brown v. C. I. R.*, 3 Cir., 180 F.2d 926, certiorari denied *C. I. R. v. Brown*, 340 U.S. 814. These cases, which are criticized in reasoned discussions in 51 Col.L.Rev. 247 and 59 Yale L.J. 1529, may be thought to go to the verge of the law in support of what are essentially intrafamily transfers. But both, being to trustees, were sufficiently outright, to be distinguishable from our present case. Both involved claimed deductions under I.R.C. § 23(a)(1) (A). In the first, a plaintiff-physician had deeded the building in which he had his office in irrevocable trust for twenty years or until the prior deaths of both himself and his wife, with their children as beneficiaries. He then leased the building back for ten years. In the second, there were two trusts, also irrevocable, terminating on the majority of the beneficiaries who were children of the settlor, coupled with an immediate leaseback of the corpus properties. In upholding the deductions, both courts expressly emphasized the independence of the trustees. It is probable that a like result would probably have obtained had the question been one of gross income under I.R.C. § 22(a). For three factors determine at-

tributability of income to the settlor of a family trust. Whether these are conjunctive tests, see *Helvering v. Clifford*, supra, 309 U.S. at page 335, or alternative, under the new Clifford regulations, U.S. Treas.Reg. No. 111, § 29.22(a)–21; *Kay v. C. I. R.*, 3 Cir., 178 F.2d 772, it seems likely that in both the cases relied on, income would have been attributable to the trusts and thus to the beneficiaries, rather than the settlors. For (1) the settlors retained no reversionary interests; (2) they retained no dispositive power over either corpus or income;[1] and (3) administrative control was not exercisable primarily for the benefit of the settlors.[2] See Alexandre, Case Method Restatement of the New Clifford Regulations, 3 Tax L.Rev. 189. . . .

Since here we find no evidence of a potential exercise of "control and management" on the part of the donee, only of "passive acquiescence to the will of the donor", *C. I. R. v. Culbertson*, supra, 337 U.S. at pages 747, 748, since the transaction is in all practical respects a "mere paper reallocation of income among the family members," *C. I. R. v. Tower*, supra, 327 U.S. at page 292, and since the husband has remained the actual enjoyer and owner of the property, payments to the wife do not constitute valid business deductions within the statute. See *Johnson v. C. I. R.*, 2 Cir., 86 F.2d 710; *W. H. Armston Co. v. C. I. R.*, 5 Cir., 188 F.2d 531.

Affirmed.

CHASE, CIRCUIT JUDGE (dissenting). Perhaps it would be desirable to protect the revenue by amending Sec. 23(a)(1)(A) to exclude from the business expense deductions now allowed those which become necessary only because of intrafamily gifts of property used, or to be used, in the business. But that is a matter to be determined by Congress and, until it acts, I think courts are bound to give effect tax-wise to gifts which are fully effective otherwise.

There is, I think, some distinction between the disallowance of the royalty and the disallowance of the rent deductions. It is that the transfer of the patent by gift to the wife was a transfer of needed business property already owned by the taxpayer which was intended to, and did, make it necessary to pay her the royalties. The gift of the money, however, which she used together with some of her own to buy the building never owned by the taxpayer was not shown to have been of money which had any con-

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1 In the Skemp case, 7 Cir., 168 F.2d 598, 599, the "taxpayer * * * did reserve the right to rent all or a part of the building 'at a rental to be determined by the trustee' "; but this does not constitute "beneficial enjoyment" of the property in the Clifford sense. Moreover, both leases back were for a term and were not coextensive with the life of the trust.

2 Here the factor of independent trusteeship is crucial. And it is in this respect that the instant case differs on its facts from the Skemp and Brown results.

nection with the business at all and the net result from the standpoint of the taxpayer and his business was merely a change in landlord. However, as I view this case, it is not necessary to rely upon this distinction.

In respect to the claimed deductions, the decisive factor as the statute is now, is whether the rent and royalty payments were "required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he had no equity." Sec. 23(a) (1) (A). The findings, based on evidence adequately supporting them, show that everything was done to transfer the legal and equitable titles both to the patent and to the building absolutely to the wife, and the ownership she thereby acquired gave her the right to whatever she could get by way of royalties and rents which were, of course, taxable to her as income. And, as Sec. 23(a) (1) (A) is now so broad that no exception is made because of the way in which business expenses become necessary, i. e., by gift or otherwise, the reasonable royalties and rents the husband paid her were, I think, well within the scope of the statute, being "required" by the license and lease arrangements, and therefore deductible. *Skemp v. Commissioner*, 7 Cir., 168 F.2d 598; *Brown v. Commissioner*, 3 Cir., 180 F.2d 926, certiorari denied 340 U.S. 814. See also *Henson v. Commissioner*, 5 Cir., 174 F.2d 846. The fact that in the Skemp and Brown cases the transfers were to independent trustees for the benefit of family members is a distinction without a difference since that bore only on the completeness of the gifts and reasonableness of the royalties and rentals paid, both here shown and found. *W. H. Armston Co. v. Commissioner*, 5 Cir., 188 F.2d 531, is distinguishable, as an instance of a disguised transfer of dividends to a large stockholder of the corporation. . . .

One other point warrants brief mention. My brothers apparently think that the taxpayer is no longer entitled to any rent deduction because, presumably, he could have used the money he gave his wife to buy the building himself and then he would have had no rent to pay. If he had done so, no doubt he would have been allowed as deductions the maintenance costs, taxes, etc., which must have been included in the rent he paid his wife to make it reasonable over all but the effect of this decision may deprive him of even them. I cannot help but think that my brothers have mistakenly applied the business purpose rule of cases like *Gregory v. Helvering*, 293 U.S. 465, to a situation where what the taxpayer did was merely to use permissible business judgment as to whether he would increase his business investment or continue to pay reasonable rent.

I would reverse and remand for a judgment for the appellant.

Notes

(A) There is a comment on this case in 65 Harv.L.Rev. 1250 (1952). See also Smith, "Shifting Income within the Family Group: Partnerships—Lease-backs—Noncommercial Annuities," 30 Taxes 995 (1952).

(B) In *Consolidated Apparel Co. v. Commissioner,* 207 F.2d 580 (C.A.7th, 1953), the deduction was allowed. There the family business rented property from an outsider. The dominant person in the business created a trust for members of the family. The trust bought the property and then rented it to the business. Thus there was not technically a "leaseback," since the business never owned the property. The court found that the trustee of the trust was independent, and that the rental fixed was proper.

Rev.Rul. 54–9, 1954–1 Cum.Bull. 20, involves a transfer of property to a family trust for ten years, with a leaseback. It was held that the rentals were not deductible and that the rental payments would be gifts.

(C) 3-pty sale + leaseback - sell prop to tax exempt foundation - with lease of prop to new corp which carries on the busn
61 Mich LR 1140 (1963)

CHAPTER 6

DEDUCTIONS AND CREDITS

Secs. 141–273 of the 1954 Code, and the corresponding provisions of the Income Tax Regulations

We now break our consideration of the questions "What is income?"—"Whose income is it?"—"When is it income?" to take up questions of deductions. This is for two reasons: because the problems in connection with deductions are ordinarily relatively simple, and because the questions which arise in connection with "When is it income?"—the accounting questions—involve deductions about as much as they do matters of income.

Consideration of deductions necessarily involves some matters of accounting, some use of accounting concepts and devices. For the most part, however, the materials of this Chapter are intended simply to illustrate the questions which arise in reducing gross income to "taxable income," for it is only "taxable income" which is subject to tax.

In the 1954 Code the statutory provisions relating to deductions are divided into a number of convenient groups. The standard deduction for individuals is given by secs. 141–145. The deduction for personal exemptions is allowed by secs. 151–154. Then we come to the long list of deductions which are generally available for corporations and for individuals who itemize their deductions, in secs. 161–175. Next there are a group of deductions which are allowable only to individuals (secs. 211–217), and a group of deductions available only to corporations, in secs. 241–248. This is followed by a number of sections spelling out items which are not deductible. Secs. 261–273. In the 1939 Code, most of these provisions were crowded into various subsections of secs. 23 and 24. The new arrangement should be much more convenient and understandable.

The materials given in this Chapter are not intended to exhaust the field of deductions. They are designed to illustrate some of the problems arising on the deduction side of the account. As always, it is the STATUTE that is of crucial importance and students should examine carefully the exact terms of the various deduction sections of the statute as well as the relevant provisions of the Regulations.[1]

Is there any constitutional right to deductions? Could Congress deny any deductions altogether, and impose a tax on gross

[1] For general discussion, see Magill and de Kosmian, "Income, Deductions, Gains and Losses," 68 Harv.L.Rev. 201 (1954).

income? *Cf. Helvering v. Independent Life Ins. Co.*, 292 U.S. 371, 381 (1934): "Unquestionably Congress has power to condition, limit or deny deductions from gross income in order to arrive at the net that it chooses to tax." See also *Pedone v. United States*, 138 Ct.Cls. 233, 151 F.Supp. 288 (1957). The question is discussed in Magill, Taxable Income, c. 9 (Rev. ed. 1945). See also "Taxability of Gross Income Under the Sixteenth Amendment," 36 Col.L.Rev. 274 (1936).

Standard Deduction

Secs. 141–145 of the 1954 Code, and secs. 1.141–1 through **1.144–2** of the Income Tax Regulations

The tax is imposed by secs. 1, 3, and 11 on "taxable income." That term is defined in sec. 63. Ordinarily, it means gross income less the aggregate of the various deductions which are allowed by Chapter 1 of the Code of 1954. An individual is, however, given the option of taking the "standard deduction" under sec. 141. If this deduction is elected, taxable income is "adjusted gross income," less the standard deduction and the personal exemptions.

The standard deduction is 10% of the "adjusted gross income" or $1,000, whichever is lesser (except that a married person filing a separate return cannot take more than $500). Thus the "adjusted gross income" is doubly important in determining taxable income on this basis. It is defined by sec. 62. This starts with gross income and then allows the deduction of certain business expenses, and also some other items. The effect is to get something like "net business income," or "net income from work and operations." Thus, in substance, a person claiming the standard deduction is allowed the deductions specified in sec. 62 *and* 10% of the balance (limited to $1,000), plus the personal exemptions.

The concept of "adjusted gross income" is also important in connection with certain other deductions, such as that for charitable contributions (sec. 170) and that for medical expenses (sec. 213).

A person who elects to be taxed under the table provided in sec. 3 automatically elects the standard deduction. In the case of a great many taxpayers, the standard deduction is very favorable and amounts to a considerable reduction in the rate of tax, since the standard deduction is often greater than the amount the taxpayer could obtain by itemizing his deductions under the regular deduction provisions of the income tax Chapter.

The general situation may perhaps be summarized as follows: Most wage earners will benefit from taking the standard deduc-

tion, and do so by electing to be taxed under the table provided by sec. 3. Most persons carrying on a substantial business, or having substantial deductions for interest on a mortgage, or taxes on a residence, or for charitable contributions, or for medical expenses, or for other purposes, will benefit by itemizing deductions. In a particular case, however, you cannot tell for sure without making the determination of "taxable income" on both bases.

Under sec. 144(b), a taxpayer may, subject to conditions stated, change his election with respect to the standard deduction. This may be important if a subsequent audit or subsequent events should change the situation from what the taxpayer understood it to be at the time he filed his return.

Personal Exemption

Secs. 151–154 of the 1954 Code, and secs. 1.151–1 through 1.153–1 of the Income Tax Regulations

The one deduction to which every individual is entitled to some extent is the deduction for personal exemptions. This includes an exemption for the taxpayer, his spouse, and for dependents of the taxpayer. The provisions of secs. 151–153 should be carefully examined. They contain a number of extra allowances and detailed rules for special situations.

Until the 1954 Code, the personal exemption was allowed as a "credit" against gross income.[1] It is now a deduction, and this seems a simplification and an improvement, although it does not appear to change the tax liability. This will explain, however, why the allowance is referred to in earlier cases as the "credit for dependents."

Problem

Suppose the taxpayer adopts 51 children in an orphanage and furnishes their entire support. Is he entitled to a deduction for a personal exemption for each of them? See *Astley v. Rogan,* 32 A.F.T.R. 1605 (S.D.Cal.1943). But see *Morrell v. Commissioner,* 107 F.2d 34 (C.C.A.3d, 1939).

ITEMIZED DEDUCTIONS

In the remaining portion of this Chapter, the general arrangement of the Internal Revenue Code of 1954 (secs. 161–273) is followed. However, some of the statutory sections are moved up to be considered with other relevant material. And a number of the sections defining items not deductible (secs. 261–273) are considered along with the deduction material, since in many

[1] See Atlas, "Personal Exemptions," 28 Taxes 519 (1950).

cases the significant problem is whether a particular item comes within a deduction section or within one of these sections saying that an item is not deductible.

It is believed that the arrangement of the material in this book will be helpful in bringing relevant material and considerations together. The arrangement of the statute is a good one, too, and the student in his work with this book should also see that he becomes closely familiar with the statutory provisions and their arrangement.

At various times there have appeared in the cases statements to the effect that deductions should be narrowly construed, and should be regarded as, in effect, favors granted to taxpayers. For example, in *Interstate Transit Lines v. Commissioner,* 319 U.S. 590 (1943), the Court referred (p. 593) to "the now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." That the burden of proving his right to a deduction should be on the taxpayer is not doubted, but the question should not be approached, it is believed in terms of "legislative grace," nor in terms of any heavier burden of proof than is on the taxpayer in all cases. Congress clearly intended to impose the tax on "taxable income," and this requires recognition of the deductions as much as of gross income. All parts of the statute should be fairly construed to determine the meaning of the language used, and without any special burden against the taxpayer.

For a discussion, see Griswold, "An Argument against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace," 56 Harv.L.Rev. 1142 (1943), reprinted in 61 So.Af.L.J. 194 (1944).

Business Expenses

Primarily **sec. 162** of the 1954 Code, but a number of other sections of the Code are relevant and are cited at the applicable places.

The basic regulations, sometimes adding much to the statute, are secs. 1.162–1 through 1.162–16 of the Income Tax Regulations.

The deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" is probably the most important deduction in the Code. Large sums are deducted under this provision every year without involving any question or controversy. It covers

such things as wages of employees, telephone, freight, postage, fuel, fire and workmen's compensation insurance, and so on.

Cases are not required to illustrate the ordinary applications of the business expense deduction. The material which follows illustrates situations where there is doubt about the availability of the deduction, or where the line must be drawn between the deduction provision and another provision or doctrine which limits or denies deductions.

Cases dealing with the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" arise in many situations. It may be helpful to consider three different types: (1) those in which the emphasis should be on "ordinary and necessary," to distinguish some business related expense which may not be deducted; (2) those in which the emphasis should be on "business," to distinguish personal expense; and (3) those in which the emphasis should be on "expense," to distinguish capital outlay.

Following this, material relating to certain special problems will be presented.

"Ordinary and Necessary"

WELCH v. HELVERING

Supreme Court of the United States, 1933. 290 U.S. 111.

MR. JUSTICE CARDOZO delivered the opinion of the Court.

The question to be determined is whether payments by a taxpayer, who is in business as a commission agent, are allowable deductions in the computation of his income if made to the creditors of a bankrupt corporation in an endeavor to strengthen his own standing and credit.

In 1922 petitioner was the secretary of the E. L. Welch Company, a Minnesota corporation, engaged in the grain business. The company was adjudged an involuntary bankrupt, and had a discharge from its debts. Thereafter the petitioner made a contract with the Kellogg Company to purchase grain for it on a commission. In order to reëstablish his relations with customers whom he had known when acting for the Welch Company and to solidify his credit and standing, he decided to pay the debts of the Welch business so far as he was able. In fulfilment of that resolve, he made payments of substantial amounts during five successive years. In 1924, the commissions were \$18,028.20, the payments \$3,975.97; in 1925, the commissions \$31,377.07, the payments \$11,968.20; in 1926, the commissions \$20,925.25, the payments \$12,815.72; in 1927, the commissions \$22,119.61, the payments \$7,379.72; and in 1928, the commis-

sions $26,177.56, the payments $11,068.25. The Commissioner ruled that these payments were not deductible from income as ordinary and necessary expenses, but were rather in the nature of capital expenditures, an outlay for the development of reputation and good will. The Board of Tax Appeals sustained the action of the Commissioner (25 B.T.A. 117), and the Court of Appeals for the Eighth Circuit affirmed. 63 F.2d 976. The case is here on certiorari.

"In computing net income there shall be allowed as deductions . . . all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Revenue Act of 1924, c. 234, 43 Stat. 253, 269, § 214; 26 U.S.C. § 955; Revenue Act of 1926, c. 27, 44 Stat. 9, 26, § 214; 26 U.S.C. App. § 955; Revenue Act of 1928, c. 852, 45 Stat. 791, 799, § 23; cf. Treasury Regulations 65, Arts. 101, 292, under the Revenue Act of 1924, and similar regulations under the Acts of 1926 and 1928.

We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. *McCulloch v. Maryland,* 4 Wheat. 316. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. *Kornhauser v. United States,* 276 U.S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

The line of demarcation is now visible between the case that is here and the one supposed for illustration. We try to classify this act as ordinary or the opposite, and the norms of conduct fail us. No longer can we have recourse to any fund of business experience, to any known business practice. Men do at times pay

the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to be read in its natural and common meaning (*Old Colony R. Co. v. Commissioner,* 284 U.S. 552, 560; *Woolford Realty Co. v. Rose,* 286 U.S. 319, 327), we should have to say that payment in such circumstances, instead of being ordinary is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

The Commissioner of Internal Revenue resorted to that standard in assessing the petitioner's income, and found that the payments in controversy came closer to capital outlays than to ordinary and necessary expenses in the operation of a business. His ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong. *Wickwire v. Reinecke,* 275 U.S. 101; *Jones v. Commissioner,* 38 F.2d 550, 552. Unless we can say from facts within our knowledge that these are ordinary and necessary expenses according to the ways of conduct and the forms of speech prevailing in the business world, the tax must be confirmed. But nothing told us by this record or within the sphere of our judicial notice permits us to give that extension to what is ordinary and necessary. Indeed, to do so would open the door to many bizarre analogies. One man has a family name that is clouded by thefts committed by an ancestor. To add to his own standing he repays the stolen money, wiping off, it may be, his income for the year. The payments figure in his tax return as ordinary expenses. Another man conceives the notion that he will be able to practice his vocation with greater ease and profit if he has an opportunity to enrich his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation. There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital assets, like the good will of an old partnership. Cf. *Colony Coal & Coke Corp. v. Commissioner,* 52 F.2d 923. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.

Many cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them

would be a futile task. They involve the appreciation of particular situations, at times with borderline conclusions. Typical illustrations are cited in the margin.*

The decree should be

Affirmed.

Notes

(A) But compare *Dunn & McCarthy, Inc. v. Commissioner*, 139 F.2d 242 (C.C.A.2d, 1943), where the president of a corporation committed suicide after borrowing large sums from the corporation's salesmen. The president's estate was insolvent, and the corporation repaid the loans to the salesmen. It was allowed to deduct the payments as a business expense.

(B) What is the meaning of "ordinary and necessary"? Does "life in all its fullness" supply a satisfactory guide? The phrase has been in the statute for a long time, and has a fairly ascertainable meaning as a practical matter. However, it would appear that an expense may be deductible as ordinary and necessary without being either ordinary or necessary! Should not "ordinary and necessary" ordinarily be given a broad meaning?

(C) Was the objection in the *Welch* case really one of the expenditure not being ordinary and necessary? Could the result be put on the ground that the taxpayer was really acquiring a capital asset, in the good will of the persons to whom the payments were made?

The following are examples of some typical decisions involving the deductibility of business expenses:

In *Knight-Campbell Music Co. v. Commissioner*, 155 F.2d 837 (C.C.A.10th, 1946), a corporation reimbursed two of its stock-

* Ordinary expenses: Commissioner v. People's-Pittsburgh Trust Co., 60 F.2d 187, expenses incurred in the defense of a criminal charge growing out of the business of the taxpayer; American Rolling Mill Co. v. Commissioner, 41 F.2d 314, contributions to a civic improvement fund by a corporation employing half of the wage earning population of the city, the payments being made, not for charity, but to add to the skill and productivity of the workmen (cf. the decisions collated in 30 Columbia Law Review 1211, 1212, and the distinctions there drawn); Corning Glass Works v. Lucas, 59 App.D.C. 168; 37 F.2d 798, donations to a hospital by a corporation whose employes with their dependents made up two thirds of the population of the city; Harris v. Lucas, 48 F.2d 187, payments of debts discharged in bankruptcy, but subject to be revived by force of a new promise. Cf. Lucas v. Ox Fiore Brush Co., 281 U.S. 115, where additional compensation, reasonable in amount, was allowed to the officers of a corporation for services previously rendered.

Not ordinary expenses: Hubinger v. Commissioner, 36 F.2d 724, payments by the taxpayer for the repair of fire damage, such payments being distinguished from those for wear and tear; Lloyd v. Commissioner, 55 F.2d 842, counsel fees incurred by the taxpayer, the president of a corporation, in prosecuting a slander suit to protect his reputation and that of his business; 105 West 55th Street v. Commissioner, 42 F.2d 849, and Blackwell Oil & Gas Co. v. Commissioner, 60 F.2d 257, gratuitous payments to stockholders in settlement of disputes between them, or to assume the expense of a lawsuit in which they had been made defendants; White v. Commissioner, 61 F.2d 726, payments in settlement of a lawsuit against a member of a partnership, the effect being to enable him to devote his undivided efforts to the partnership business and also to protect its credit.

holders for amounts which they had paid to attorneys for services rendered in a controversy between them and the corporation. It was held that the corporation could not deduct the expense.

In *Hochschield v. Commissioner,* 161 F.2d 817 (C.C.A.2d, 1947), an individual was allowed to deduct legal expenses incurred in defending against a stockholder's derivative suit brought against him. The suit was brought to recover stock, or its proceeds, for the corporation. The court held, however, that this did not make the attorneys' fees a capital expenditure. They were an element of the taxpayer's business as a fiduciary and were deductible as a business expense.

On the other hand, in *Friedman v. Delaney,* 171 F.2d 269 (C.A.1st, 1949), a lawyer made a payment for a client in fulfillment of a moral obligation, which was not legally enforceable. The Court held that the payment could not be deducted either as a business expense or as a loss. See also *Commissioner v. Heide,* 165 F.2d 699 (C.C.A.2d, 1948).

There has been a noticeable tendency on the part of the courts to take a restrictive view of the deduction for business expenses. This seems unwarranted and unfortunate.

"Trade or business." What is a "trade or business"? In *Deputy v. duPont,* 308 U.S. 488 (1940), the majority of the Court took a very narrow view of the term, but it seems a fair evaluation to say that subsequent developments have receded from that point.

See also *Interstate Transit Lines v. Commissioner,* 319 U.S. 590 (1943), where the taxpayer was required by the Railroad Commission of California to do business in California through a California corporation. Accordingly it organized a California corporation as a wholly owned subsidiary. The taxpayer kept all of the revenues which it collected and agreed to pay the deficit of the subsidiary. The Court held that the amount so paid could not be deducted by the taxpayer, as it was not its business to conduct operations in California. Cf. *National Carbide Corp. v. Commissioner,* set out at p. 248, above.

Is a corporate officer or employee engaged in a "trade or business" of his own, so that he may deduct the expenses that he incurs in connection with it? It would seem that the answer should be clearly affirmative. For discussion, see Lembert, "Who Can Deduct a Business Expense," 11 Tax L.Rev. 433 (1956); Osmund, "The Corporate Executive and the Business Expense Deduction," 33 Taxes 68 (1955); "Deductibility of Expenses Incurred for the Benefit of Another," 66 Harv.L.Rev. 1508 (1953). In *Motch v.*

Commissioner, 180 F.2d 859 (C.A.6th, 1950), the court said that an army officer was not engaged in a trade or business, and could not deduct expenses he incurred in the pursuit of his duties. The Treasury promptly announced that it "will not follow" this decision. I.T. 4012, 1950–1 Cum.Bull. 33. See also sec. 7701(a)(26) of the 1954 Code.

If the employee is entitled to get reimbursement from his employer, but chooses not to do so, bearing the burden of the expense himself, the courts tend to hold that he cannot deduct the expense, on the ground that it is not his expense but his employer's. See *Heidt v. Commissioner,* 274 F.2d 25 (C.A.7th, 1959).

Is a lawyer who owns an apartment house engaged in a trade or business so far as the apartment house is concerned? See *Fackler v. Commissioner,* 133 F.2d 509 (C.C.A.6th, 1943). But see sec. 1.1221–1 of the Income Tax Regulations.[1] The problem is not of importance as far as deductions are concerned (because of the provision of sec. 212 of the 1954 Code), but it is still relevant in determining whether a loss on the sale of such property is deductible in full under sec. 1231 of the 1954 Code. May a person be engaged in two or more trades or businesses?

Litigation expenses. A great many questions, some of them rather difficult, may be encountered in connection with the deductibility of legal expenses in litigation, and judgments resulting from litigation. The expenses may be personal, or capital—or they may be deductible. (See the note on tax litigation expenses on p. 369(C), below.) General discussion may be found in Brookes, "Litigation Expenses and the Income Tax," 12 Tax L. Rev. 241 (1957); Plumb, "Income Tax on Gains and Losses in Litigation," 25 Corn.L.Q. 221, 26 Corn.L.Q. 16 (1940); Lynch, "Legal Expenses as Deductions from Income," 12 Fordham L.Rev. 8 (1943). See also Harnett, "Torts and Taxes," 27 N.Y.U.L.Rev. 614 (1952).

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[1] See "When is Real Estate Held for the Production of Income Used in the Trade or Business of the Taxpayer?" 59 Harv.L.Rev. 119 (1945); Braunfeld, "Real Estate Losses," 23 Taxes 828 (1945).

Distinction Between Business Expenses and Personal, Living, and Family Expenses

Sec. 262 of the 1954 Code, taken with sec. 162(a)

COHAN v. COMMISSIONER

United States Circuit Court of Appeals, Second Circuit, 1930. 39 F.2d 540.

L. HAND, CIRCUIT JUDGE.[1] . . .

In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board he estimated that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following fiscal year, fifty-five thousand dollars in all. The Board refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for computation, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions much be such. We think that the Board was in error as to this and must reconsider the evidence.

Note

See Kramer, "Estimated Income and Expense in the Tax Law," 32 Taxes 906 (1954); "Business Expense Deduction—The Cohan Rule," 36 Taxes 177 (1958).

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1 Only the portion of the opinion relating to this point is given.

RICHARD A. SUTTER

Tax Court of the United States, 1953. 21 T.C. 170.

[The taxpayer was a doctor engaged in the specialized practice of industrial medicine. The nature of the expenses claimed as deductions appears from the opinion.]

OPPER, JUDGE. While the sole issue is deductibility as business expense of a number of items claimed by petitioner, the purposes of the expenditures and the grounds of their disallowance place them in separate categories and require individual disposition for each class. Of the seven types of items for which deductions were claimed we have concluded that five should be disallowed entirely and that the other two are deductible only to a limited extent.

Running through most of the contested items is the stubborn thread of a single problem which has never apparently been squarely and expressly passed upon. Cf. e. g., *James Schulz,* 16 T.C. 401. When a taxpayer in the course of supplying food or entertainment or making other outlays customarily regarded as ordinary and necessary includes an amount attributable to himself or his family such as the payment for his own meals, is that portion of the expenditure an ordinary and necessary business expense on the one hand or a nondeductible personal item on the other?

It seems to us that while each situation will of course be governed by its individual facts the general principle necessarily emerges somewhat as follows: The cost of meals, entertainment, and similar items for one's self and one's dependents, at least if not incurred while away from home in the pursuit of one's business, see section 23(a)(1)(A), Internal Revenue Code, are ordinarily and by their very nature personal expenditures forbidden deduction by section 24(a)(1). The presumption, no doubt rebuttable, must accordingly arise that such costs are nondeductible. In addition to the burden imposed by the necessity of overcoming respondent's determination we think the presumptive nondeductibility of personal expenses may be overcome only by clear and detailed evidence as to each instance that the expenditure in question was different from or in excess of that which would have been made for the taxpayer's personal purposes. Where such evidence is absent we conclude that even under the *Cohan* [1] rule no amount whatever for such expenses may properly be claimed.

The items which we think must be wholly disallowed are those claimed for gifts to elevator operators, parking lot attendants,

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1 Cohan v. Commissioner, (C.A.2) 39 F.2d 540.

hospital employees, and others in similar occupations; the amount spent for a hunting trip as to which there is inadequate proof of a direct connection with petitioner's business income, *Louis Boehm,* 35 B.T.A. 1106; gifts to various medical associates; and the expense of publishing an article circulated by petitioner to a miscellaneous group of recipients even though some may have included those with whom petitioner had business relations. As to all of these items we have found as facts on this subject all those requested by petitioner. See Rules of Practice before the Tax Court of the United States, Rule 35(e)(3). On the basis of those findings it is impossible to conclude that petitioner has borne the burden of showing in what respect and to what if any extent these items contributed to the earning of his income. The deductions must accordingly be denied. *Louis Boehm, supra; James Schulz, supra; Reginald Denny,* 33 B.T.A. 738; *Home Guaranty Abstract Co.,* 8 T.C. 617; *Walter J. Munro,* 19 B.T.A. 71. Cf. *E. E. Dickinson,* 8 B.T.A. 722.

The deduction for the cost of lunches was apparently almost entirely payment for petitioner's own meals when he attended such functions as meetings of the Chamber of Commerce. There is no evidence that these costs were any greater than expenditures which petitioner would have been required to make in any event for his own personal purposes. They must consequently be disallowed.

The remaining two items consist of entertainment expenses and the cost of maintenance and depreciation of a cabin cruiser belonging to petitioner. While this proceeding is distinguishable from *Cohan v. Commissioner, supra,* in that the total amount of the expenses is not conjectural but has either been stipulated or shown by adequate evidence, we nevertheless regard an allocation as required because it is evident that only a part of these conceded expenditures may be characterized as the ordinary and necessary consequences of petitioner's trade or business. To some extent they were entirely personal in nature being on the one hand costs of entertainment for petitioner and his family and on the other partly social occasions. In some degree they were also apparently a means of enhancing petitioner's prestige and the future possibility of expanding his clinic business so as to be the means of creating a capital asset comparable to good will. See 4 Mertens "Law of Federal Income Taxation" 367, and cases cited. And how these elements, particularly the former, may be separated from actual business expenses is not, in spite of petitioner's careful record-keeping, to any extent discoverable from the evidence. This inexactitude is, in the language of the *Cohan* case, the result of petitioner's own conduct. Because of these considerations we have found that the amounts deductible by petitioner as ordinary and necessary expenses in

the two allowable categories of entertainment and cabin cruiser expenses and depreciation are 25 per cent of those now claimed by him. Cf. *John A. Brander,* 3 B.T.A. 231, with *E. E. Dickinson, supra.* These items are detailed in the record and can readily be recomputed by the parties.

Reviewed by the Court.

Decisions will be entered under Rule 50.

REVENUE RULING 54–195

Internal Revenue Service, 1954. 1954–1 Cum.Bull. 47.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to clarify Internal Revenue Service policy so as to promote uniformity in the application of the law and regulations to questions relating to the substantiation and allowance of deductions claimed under section 23(a)(1) of the Internal Revenue Code.

SEC. 2. PERSONAL AND FICTITIOUS EXPENSE DEDUCTIONS.

It appears that some taxpayers are erroneously claiming personal, living, or family expenses as business deductions. Also, instances have been found in which taxpayers have claimed fictitious deductions, or have otherwise made excessive claims with willful intent to defraud. Since the law specifically provides that only ordinary and necessary trade or business expenses properly may be claimed as deductions under section 23(a)(1), it follows that each taxpayer has the responsibility to claim as deductions only those items which the law so describes. It follows also that each representative of the Commissioner of Internal Revenue has the responsibility to make certain that no nondeductible items are allowed. Thus, each internal revenue agent is charged with the duty of closely scrutinizing claimed deductions for business expense and dealing appropriately with instances where personal expenses are claimed as business deductions. In any instance in which the examination of an income tax return reveals that fictitious deductions have been claimed, the case will be dealt with in accordance with the appropriate established procedures.

SEC. 3. ORDINARY AND NECESSARY BUSINESS EXPENSES.

.01 In the verification of deductions claimed for expenses paid or incurred in connection with a taxpayer's trade or business, problems constantly arise with respect to the verification of those deductions which are based upon a substantial number of small items of expenditure since they often are not susceptible of complete substantiation by documentary evidence. Typical of the deductions in which such questions arise are those for traveling and entertainment expense.

.02 This Revenue Ruling is not intended to require or permit that the taxpayer be relieved of the burden of proof in such matters nor to sanction any failure to comply with the record-keeping requirements of the law and regulations. It deals primarily with problems of evidence and its evaluation that are encountered in every day, practical administration of the tax laws. In connection with the consideration of deductions for items such as traveling and entertainment expense, the examining officer should exercise careful judgment which will permit reasonable determinations under the law and regulations, provided he is satisfied that there is a proper basis for some allowance. This will involve consideration of such matters as the extent to which detailed verification is required, the papers or records essential to adequate substantiation, and the weight to be accorded oral statements and explanations. Such elements necessarily will vary according to the nature and relative tax importance of the items involved and the general circumstances surrounding the entire case.

.03 Close approximations of items not fully supported by documentary proof can very frequently be reached by reconstruction through resort to reliable secondary sources of information and collateral evidence. For example, in connection with a claimed item of traveling expense it might be possible for a taxpayer to satisfy the examiner that he was in a travel status a certain number of days out of each month or year but impossible for him to establish the details of all his various items of travel expense by documentary proof. In such a case rail fares or plane fares can be ascertained with exactness and automobile costs approximated on the basis of mileage covered. A reasonable approximation of meals and lodging might be based upon receipted hotel bills or by applying a daily rate (determined upon the basis of actual costs prevailing in the particular community for comparable accommodations) to the provable days of travel. Items such as tips, taxi fares, and the like can be based upon a reasonable approximation.

.04 In connection with the determination of factual matters of this type, due consideration should be given to the reasonableness of the taxpayer's stated expenditures for the claimed purposes in relation to his reported income, to the reliability and accuracy of his records in connection with other items more readily lending themselves to detailed record-keeping, and to the general credibility of his statements in the light of the entire record in the case. Disallowing amounts claimed for such items merely because there is available no documentary evidence which will establish the precise amount beyond any reasonable doubt ignores commonly-recognized business practice as well as the fact that proof may be established by credible oral testimony. On the

other hand, it is not Service policy to allow a percentage or other arbitrarily-computed portion of deductions of this character merely for the purpose of settlement.

Notes

(A) See Levin and Mitosky, "Tax Saving Practices of Artists and Entertainers," 31 Taxes 21 (1953); Stuart, "Social Club Dues and Expenses," 31 Taxes 69 (1953).

(B) In *Ralph E. Larrabee,* 33 T.C. 838 (1960), the expenses of maintaining and operating a 161 foot yacht were disallowed as a deduction, though the vessel was used to some extent for the entertainment of customers.

(C) In *Wright v. Commissioner,* 274 F.2d 883 (C.A.6th, 1960), the taxpayer and his wife took a trip around the world, visiting their son in Japan. They kept a careful diary, and unsuccessfully sought to sell this to a publisher on their return. It was held that they could not deduct the expenses of the trip.

COUGHLIN v. COMMISSIONER

United States Court of Appeals, Second Circuit, 1953. 203 F.2d 307.

CHASE, CIRCUIT JUDGE. The petitioner has been a member of the bar for many years and in 1944 was admitted to practice before the Treasury Department. In 1946 he was in active practice in Binghamton, N. Y., as a member of a firm of lawyers there. The firm engaged in general practice but did considerable work which required at least one member to be skilled in matters pertaining to Federal taxation and to maintain such skill by keeping informed as to changes in the tax laws and the significance of pertinent court decisions when made. His partners relied on him to keep advised on that subject and he accepted that responsibility. One of the various ways in which he discharged it was by attending, in the above mentioned year, the Fifth Annual Institute on Federal Taxation which was conducted in New York City under the sponsorship of the Division of General Education of New York University. In so doing he incurred expenses for tuition, travel, board and lodging of $305, which he claimed as an allowable deduction under section 23(a)(1)(A) I.R.C., as ordinary and necessary expenses incurred in carrying on a trade or business and no question is raised as to their reasonableness in amount. The Commissioner disallowed the deduction and the Tax Court, four judges dissenting, upheld the disallowance on the ground that the expenses were non-business ones "because of the educational and personal nature of the object pursued by the petioner."

The Tax Court found that the Institute on Federal Taxation was not conducted for the benefit of those unversed in the subject of Federal taxation and students were warned away. In

1946, it was attended by 408 attorneys, accountants, trust officers, executives of corporations and the like. In 1947, over 1500 of such people from many states were in attendance. It was "designed by its sponsors to provide a place and atmosphere where practitioners could gather trends, thinking and developments in the field of Federal taxation from experts accomplished in that field."

Thus there is posed for solution a problem which involves no dispute as to the basic facts but is, indeed, baffling because, as is so often true of legal problems, the correct result depends upon how to give the facts the right order of importance.

We may start by noticing that the petitioner does not rely upon section 23(a)(2) which permits the deduction of certain non-trade or non-business expenses, but rests entirely upon his contention that the deduction he took was allowable as an ordinary and necessary expense incurred in the practice of his profession. The expenses were deductible under section 23(a)(1)(A) if they were "directly connected with" or "proximately resulted from" the practice of his profession. *Kornhauser v. United States,* 276 U.S. 145, 153. And if it were usual for lawyers in practice similar to his to incur such expenses they were "ordinary." *Deputy v. duPont,* 308 U.S. 488, 495. They were also "necessary" if appropriate and helpful. *Welch v. Helvering,* 290 U.S. 111. But this is an instance emphasizing how dim a line is drawn between expenses which are deductible because incurred in trade or business, i. e., because professional, and those which are non-deductible because personal. Section 24(a)(1) of Title 26.

The respondent relies upon T.R. 111, § 29.23(a)–15, which provides that "expenses of taking special courses or training" are not allowable as deductions under section 23(a)(2). But section 23(a)(2) concerns non-trade or non-business expenses. It is not necessary to decide whether, in the light of the regulation, an expense of the nature here involved would be deductible, if incurred in connection with a profit-making venture that is not a trade or business. It will suffice to say that, since the expense was incurred in a trade or business within the meaning of section 23(a)(1)(A), the regulation interpreting section 23(a)(2) is not a bar to allowance here.

In *Welch v. Helvering,* supra, 290 U.S. at page 115, there is a dictum that the cost of acquiring learning is a personal expense. But the issue decided in that case is far removed from the one involved here. There the taxpayer paid debts for which he was not legally liable whose payment enhanced his reputation for personal integrity and consequently the value of the good will of his business, and it was held that these payments were personal expenses. The general reference to the cost of education as a personal expense was made by way of illustrating the point then un-

der decision, and it related to that knowledge which is obtained for its own sake as an addition to one's cultural background or for possible use in some work which might be started in the future. There was no indication that an exception is not to be made where the information acquired was needed for use in a lawyer's established practice.

T.R. 111, § 29.23(a)–5, makes clear that among the expenses which a professional man may deduct under Section 23(a)(1)(A) are dues to professional societies, subscriptions to professional journals, and amounts currently expended for books whose useful life is short. Such expenses as are here in question are not expressly included or excluded, but they are analogous to those above stated which are expressly characterized as allowable deductions.

This situation is closely akin to that in *Hill v. Commissioner,* 4 Cir., 181 F.2d 906, where the expenses incurred by a teacher in attending a summer school were held deductible. The only difference is in the degree of necessity which prompted the incurrence of the expenses. The teacher couldn't retain her position unless she complied with the requirements for the renewal of her teaching certificate; and an optional way to do that, and the one she chose, was to take courses in education at a recognized institution of learning. Here the petitioner did not need a renewal of his license to practice and it may be assumed that he could have continued as a member of his firm whether or not he kept currently informed as to the law of Federal taxation. But he was morally bound to keep so informed and did so in part by means of his attendance at this session of the Institute. It was a way well adapted to fulfill his professional duty to keep sharp the tools he actually used in his going trade or business. It may be that the knowledge he thus gained incidentally increased his fund of learning in general and, in that sense, the cost of acquiring it may have been a personal expense; but we think that the immediate, over-all professional need to incur the expenses in order to perform his work with due regard to the current status of the law so overshadows the personal aspect that it is the decisive feature.

It serves also to distinguish these expenditures from those made to acquire a capital asset. Even if in its cultural aspect knowledge should for tax purposes be considered in the nature of a capital asset as was suggested in *Welch v. Helvering,* supra, the rather evanescent character of that for which the petitioner spent his money deprives it of the sort of permanency such a concept embraces.

Decision reversed and cause remanded for the allowance of the deduction.

Notes

(A) There is a comment in 6 Stanford L.Rev. 547 (1954).

(B) A Regulation with respect to "Expenses for Education" is found in sec. 1.162–5 of the Income Tax Regulations. This is extensively interpreted and illustrated in Rev.Rul. 60–97, 1960–1 Cum.Bull. ——.

In *John S. Watson,* 31 T.C. 1014 (1959), the court relied on this regulation and held that a physician in the general practice of internal medicine could deduct the cost of a course in psychiatric analysis and techniques which he took for the purpose of maintaining and improving his skill in his general practice.

(C) Suppose a father employs his minor child in his business, and requires the child to use the earnings for the purchase of clothing and the like, thereby discharging the father's support obligation. In Rev.Rul. 59–110, 1959–1 Cum.Bull. 45, the Treasury ruled that such wages are deductible where a bona fide employment relationship exists.

I. T. 3929

Bureau of Internal Revenue, 1948. 1948–2 Cum.Bull. 29.

Advice is requested whether the expense incurred by a professional writer in protecting his residence from fire, a part of the residence being used as his office, is deductible as a business expense under section 23(a)(1)(A) of the Internal Revenue Code.

In the instant case, the taxpayer keeps in that part of his residence used as an office a large quantity of books, manuscripts, and documents which are indispensable in the conduct of his profession. During the fall of 1947, at a time when forest fires were raging in the immediate vicinity of the taxpayer's home, he employed a large crew of men and otherwise went to considerable expense in the protection of his property. His efforts proved successful, and he escaped any fire loss whatever.

Section 23(a)(1)(A) of the Internal Revenue Code provides in part that in computing net income there shall be allowed as deductions all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 29.23(a)–5 of Regulations 111 recognizes that the pursuit of a profession falls within the scope of a trade or business. Section 29.24–1 of Regulations 111 recognizes that an allocation of the expense of maintenance of residential property may be made where a portion of such property is devoted to business purposes.

It is held that a portion of the expense incurred by a professional writer in protecting his residence from fire, a part of the residence being used as his office, is deductible as an ordinary and necessary business expense under section 23(a)(1)(A) of the Internal Revenue Code. The amount which is so deductible may

not exceed the proportion of the expense which the value of the rooms used as an office and their contents bears to the value of the residence and its entire contents.

Notes

May a banker who runs a farm on Long Island, or a racing stable, deduct his losses? See *Whitney v. Commissioner,* 73 F.2d 589 (C.C.A.3d, 1934); G.C.M. 21103, 1939–1 Cum.Bull. 164.[1] In *Cecil v. Commissioner,* 100 F.2d 896 (C.C.A.4th, 1939), the owner of the Biltmore Estate, near Asheville, North Carolina, which is open to the public for an admission fee, was allowed to deduct the expenses of maintaining and operating the property.

In *McDonald v. Commissioner,* 323 U.S. 57 (1944) the Court held (though without agreement as to the reasons) that assessments paid to a party fund by the taxpayer who was a state judge were not deductible. These assessments went to the general campaign fund of the party, and had to be paid if the taxpayer was to obtain the support of the party organization. The Court held that if campaign expenditures were to be deductible, the policy indicating it should be more clearly stated by Congress.

See Bloom, "Tax Results of Political Contributions," 36 B.U.L. Rev. 170 (1956).

"Hobby losses." Sec. 270 of the Code contains an elaborate provision limiting the deductions allowed to an individual where he has losses from a trade or business of over $50,000 annually over a period of five years or more. This is designed to prevent a wealthy taxpayer from running a business as a hobby, such as a racing stable or a newspaper, and deducting the losses against his income in high brackets from other sources. It seems likely that few tax lawyers will encounter this provision in actual practice.

Expenses for care of dependents. Where a husband and wife both work, it has long been the rule that the cost of a nursemaid to care for children is a personal expense, and not deductible. *Mildred A. O'Connor,* 6 T.C. 323 (1946).

This rule is changed to a limited extent by sec. 214 of the 1954 Code, which allows a deduction to women or to widowers for the expenses of care of dependents. This is limited to $600 per year, and there are further limitations in the case of married women.

1 See Breckwoldt and Lockwood, "Gentlemen Farmers," 28 Taxes 603 (1950).

The Line Between Business Expenses and Capital Expenditures

Primarily **sec. 263** of the 1954 Code in relation to sec. 162(a)

HOTEL KINGKADE v. COMMISSIONER

United States Court of Appeals, Tenth Circuit, 1950. 180 F.2d 310.

BRATTON, CIRCUIT JUDGE. This petition to review a decision of the Tax Court presents the question whether in determining the liability of Hotel Kingkade Company for income and declared value excess-profits taxes certain expenditures were deductible from gross income as ordinary and necessary expenses in carrying on a trade or business.

Section 23(a) of the Internal Revenue Code provides in presently material part that in computing net income there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. And section 29.23(a)–4, of Treasury Regulation 111, provides in substance that the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life but keep it in ordinary efficient operating condition may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures; and that repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept.

In 1910, Andrew Kingkade leased to L. Rardin and C. T. Williams for a term of ten years a hotel building then under construction in Oklahoma City, Oklahoma, and afterwards known as the Kingkade Hotel. The construction of the building was completed in 1911; the lessees furnished and equipped it for a hotel; and they opened it for business. In 1912, Kingkade Hotel Company, hereinafter referred to as the owning company, was organized to acquire and during that year did acquire from Andrew Kingkade the building and the lease covering it. The lessees failed in business, and in 1914 the owning company acquired the furnishings and equipment which the lessees had installed in the hotel. In 1923, the owning company acquired the Bristol Hotel in Oklahoma City, completely furnished; in 1933, the owning company acquired the Ewell Hotel in Oklahoma City, unfurnished, with garage and parking lot; and since such dates the owning company has owned the three properties. In 1914, Hotel Kingkade Company, hereinafter referred to as the taxpayer,

was organized for the purpose of operating the Hotel Kingkade. On April 28, 1914, the lessees assigned to the taxpayer the lease covering the hotel; and since that time, the taxpayer has operated the hotel. At all times after the lease expired in 1920, the taxpayer operated the hotel pursuant to an oral understanding with the owning company that the rental would be in accordance with the ability of the taxpayer to pay rent, depending on the amount of its profits. Since 1923, the taxpayer also operated the Bristol Hotel in accordance with such arrangement. And since 1933, it has operated the Ewell Hotel, garage, and parking lot under similar arrangement, all subject to an understanding however that the taxpayer would pay the cost of repairs and maintenance and pay the balance of its income to the owning company as rent. Pursuant to such understanding, the taxpayer currently paid its profits to the owning company as rental unless some portion thereof was retained as a reserve to meet some anticipated expense. In 1942, the owning company was out of debt and permitted the taxpayer to retain some of its profits to create a cash reserve to meet operating requirements in later years. The controlling stock interest in the owning company and in the taxpayer was held by Andrew Kingkade and his wife, their son, and the son's wife and daughter.

In 1944, 1945, and 1946, the taxpayer expended $9,310.48, $5,-497.16, and $3,959.66, respectively, for carpets and rugs, padding under carpets, refrigerator with ice maker, reflue and repair heating and water boilers, closet tanks, bowls, pipe, toilet covers, cloth material, dishwasher, removing old hot water tank, adding machine, fire hose and appliances, electric fans, roofing and sheet metal contracts, cooking ranges, potato peeler and trays, and tile work on kitchen walls and showers. Virtually all of the equipment thus purchased was to replace like equipment which had become worn out and had to be discarded. All of the expenditures were treated on the books of the taxpayer as current repairs, replacements, and maintenance, and were charged to expense. In its income and declared value excess-profits tax returns, the taxpayer treated such expenditures as expenses deductible from gross income under the provisions of section 23(a) (1) (A), supra. The Commissioner determined that the amounts claimed as deductions for repairs and maintenance constituted capital expenditures and therefore were not deductible as business expenses. The Tax Court sustained the action of the Commissioner, and the taxpayer seasonably sought review. The taxpayer does not complain of the decision of the Tax Court in respect to the expenditure for repair of the roof, but in all other respects the decision is challenged.

It is not always easy to draw the boundary line between capital outlays and current expenses. The problem sometimes presents

difficulty. In some instances an expenditure should be classified as one or the other depending upon the exercise of judgment in the light of the pertinent circumstances and the application of good accounting principles. Generally an expenditure should be treated as of a capital nature if it brings about the acquisition of an asset having a period of useful life in excess of one year or if it secures a like advantage to the taxpayer which has a life of more than one year. And in order to constitute an ordinary and necessary expense deductible from gross income under section 23(a), the expenditure must relate to the carrying on of the business, it must arise in the normalcy of the particular business, and it must be incurred in the usual course of the operation of the business. It may be unusual and it may seldom recur. But it must be customary and of frequent occurrence in the type of business involved. *Deputy v. duPont,* 308 U.S. 488; *Hales-Mullaly v. Commissioner of Internal Revenue,* 131 F.2d 509.

These expenditures were not customary and of frequent occurrence. They were not incurred or made for incidental repairs which neither added to the value of the property nor appreciably prolonged its life as a hotel but merely kept it in an ordinarily efficient operating condition. Some were for repairs of a permanent nature which materially added to the value of the property and appreciably prolonged its life as an operating hotel; and others were for replacements of furnishings and equipment having a useful life in excess of one year. They were expenditures of a capital nature, not ordinary and necessary expenses incurred and paid in carrying on a trade or business. *Parkersburg Iron & Steel Co. v. Burnet,* 48 F.2d 163; *Fire Companies Bldg. Corporation v. Burnet,* 57 F.2d 943; *Beaudry v. Commissioner of Internal Revenue,* 150 F.2d 20.

But the taxpayer argues that it did not make the expenditures for the purpose of increasing the value of the property. It says in effect that not being the owner of the property it had no interest in increasing its value. It stresses the point that it made the expenditures for the purpose of keeping the premises in first class condition, as required by the lease, and that therefore the expenditures were not capital in nature. The taxpayer was lessee of the property. Except as to the roof, the written lease provided that the lessees should keep the building and appurtenances in first class condition and should surrender the premises at the end of the term in as good condition as the reasonable use thereof would permit. But that provision did not obligate the taxpayer to make at its own expense repairs or furnish replacements and equipment of the kind and to the extent involved here. The lease also provided that the lessees should conduct a first class hotel in the premises. But that provision had reference to the management and operation of the hotel rather than extended repairs,

replacements, furnishings and equipment. The expenditures were capital in nature rather than ordinary and necessary expenses incurred in the carrying on of a trade or business, even though the taxpayer was merely an operating lessee of the property. *Duffy v. Central R. R.*, 268 U.S. 55; *Yeager v. United States*, 32 F.2d 402.

Another contention of the taxpayer is that extending over a long period of years prior to the years in question it consistently followed the practice in keeping its books and records and in making its income tax returns of treating as expenses expenditures made for repairs, replacements, and maintenance; that such practice was not challenged prior to the years in question; and that in the circumstances it would be highly unfair to the taxpayer to change its method of accounting. In effect, the taxpayer seeks to invoke the doctrine of estoppel against the Commissioner to treat the expenditures in question other than as necessary and ordinary expenses, within the purview of section 23(a) of the Internal Revenue Code. Section 41 of the Internal Revenue Code, provides among other things that net income shall be computed on the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of the taxpayer; but that if the method does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect it. The record is sketchy in respect to the nature and extent of repairs, replacements, and maintenance for which the taxpayer claimed deductions as ordinary and necessary expenses in earlier years. But assuming that they were fairly comparable to those involved here, the practice of the taxpayer in deducting as ordinary and necessary expenses the expenditures made for them was not the correct method of treating such expenditures; and to the extent that such deductions entered into the ultimate result, the returns did not clearly and accurately reflect net income subject to tax. The returns were accepted without challenge, but the acceptance of them did not preclude the Commissioner from insisting that a method be used for the years in question which would clearly reflect the income. *Niles Bement Pond Co. v. United States*, 281 U.S. 357; *Mt. Vernon Trust Co. v. Commissioner of Internal Revenue*, 75 F.2d 938, certiorari denied, 296 U.S. 587. . . .

The decision of the Tax Court is affirmed.

Notes

(A) Where should the line between ordinary expenses and capital expenditures be drawn? See the discussion in sec. 1.263 of the Income Tax Regulations. Must any expenditure made in connection with the production of income over a period of more

than one year be capitalized? Though logically sound, is it wise to require the capitalization of the cost of relatively small items of equipment, such as typewriters or adding machines. If their cost is to be allowed as a current deduction, how is the line to be drawn?

(B) *E. H. Sheldon & Co. v. Commissioner*, 214 F.2d 655 (C.A. 6th, 1954), involved a company whose business was the design, manufacture, and installation of complete laboratory equipment. It published and distributed rather elaborate catalogues at intervals of five or six years. It published a catalogue in September 1946, and several thousand copies were printed and distributed. The cost of preparing this catalogue was sustained in 1945 and 1946, and the taxpayer deducted this cost in those years. The Commissioner disallowed the deduction on the ground that the cost of the catalogues was recoverable only through amortization over a period of useful life of five years. This was sustained by the Tax Court. On appeal to the court of appeals, however, the deduction was allowed. The court said that advertising expenses, even though incurred heavily in a single year with resulting benefits over future years, is nevertheless a deductible expense for the year in which expended.

(C) For general discussions, see Graves, "Capital Expenditures v. Current Deductions," 37 Taxes 1126 (1959); Palley, "Moving and Rearrangement Expenses," 36 Taxes 189 (1958); Cook, "Repairs Versus Capital Expenditures," 13 Taxes 231 (1958); Shugerman, "Basic Criteria for Distinguishing Revenue Charges from Capital Expenditures in Income Tax Computations," 49 Mich.L.Rev. 213 (1950); Kramer, "Revenue Charges v. Capital Expenditures," 32 Taxes 32 (1954); "Income Tax Accounting: Business Expense or Capital Outlay," 47 Harv.L. Rev. 669 (1934).

Illustrations of the results reached by the courts in these cases are set out below:

Improvements, to be capitalized:

Substantial wire fence erected around plant at suggestion of government in war time. *Russell Box Co. v. Commissioner*, 208 F.2d 452 (C.A.1st, 1953).

Installation of overhead doors and replacement of motors. *Acme Pie Co.*, B.T.A. Memo., August 30, 1940.

Erection of a permanent partition. *Halsam Products Co.*, T.C. Memo., Jan. 29, 1952.

Lowering basement floor to adapt basement to a different use. *Difco Laboratories, Inc.*, 10 T.C. 660 (1948).

Repairs, currently deductible:

Lining walls and basement floors with concrete to prevent oil seepage which threatened continuous operation of plant. *Midland Empire Packing Co.*, 14 T.C. 635 (1950).

Tuck pointing and cleaning exterior walls of brick office building. *City National Bank*, T.C. Memo., April 23, 1952.

Patching floors, *Sanford Mills*, 14 B.T.A. 1210 (1930).

Expenditure of $900,000 for drilling and grouting to prevent building from sinking. *Commissioner v. American Bemberg Co.*, 177 F.2d 200 (C.A.6th, 1949).

Questions of expenses which must be capitalized arise in other types of situations also. Consider the two following situations:

(A) In *Main & McKinney Bldg. Co. v. Commissioner,* 113 F.2d 81 (C.C.A.5th, 1940), it was held that advance payments made over a period of 25 years for a 98-year lease must be capitalized and the deduction spread over the whole 98-year period. See also *Southwestern Hotel Co. v. United States,* 115 F.2d 686 (C.C. A.5th, 1940), cert. den. 313 U.S. 703 (1940), where a similar result was reached where the lessee paid as "additional rentals" the annual payments on the principal on the lessor's mortgage.

(B) May the commissions paid to a broker on the purchase or sale of securities be deducted, or must they be treated as capital payments? Why does it make any difference? Will the result depend on whether the taxpayer is engaged in the business of buying and selling securities? See *Helvering v. Winmill,* 305 U.S. 79 (1938); *Spreckels v. Helvering,* 315 U.S. 626 (1942).

(C) *Millinery Center Building Corp. v. Commissioner,* 350 U.S. 456 (1956), involved a company which had a twenty-one year lease, with an option to renew for two further twenty-one year periods. It put up a $3,000,000 building at the beginning of the lease, and fully depreciated this over the original twenty-one year period. Just before the end of that period, it exercised its option to renew for a second twenty-one years. Shortly thereafter, it purchased the fee from the owner for $2,100,000, of which $1,440,000 was allocated to the building. It sought to deduct the $1,440,000 in the year of purchase. This was refused, and it was held that the taxpayer must capitalize the payment. It was further held that depreciation with respect to the payment for the building must be taken over the remaining useful life of the building, and not over the remainder of the second twenty-one year term of the lease.

It has long been held that the expenses of organizing or reorganizing a corporation are capital and are not deductible—except perhaps when the corporation is dissolved. This is now covered by a new provision in the 1954 Code—**sec. 248**—which allows the deduction of these expenses over a period of five years or more. See Lauritzen, "How Can Legal Fees in a Corporate Reorganization Be Made Deductible?" 1 Tax Counselor's Q. 109 (1957).

A Regulation under sec. 248 of the 1954 Code has been issued as sec. 1.248–1 of the Income Tax Regulations.

Another type of capital expenditure is illustrated by *Grace National Bank of New York,* 15 T.C. 563 (1950), affirmed (mem.), 189 F.2d 966 (C.A.2d, 1951). That case involved a fee of $5,000 paid by the taxpayer for admission to the New York Clearing House Association. It was held that it was not deductible. If it

cannot be deducted, how should such a payment be accounted for? Will it ever be taken into account for tax purposes?

A similar sort of question arises with respect to the expenses of liquidating a corporation.[1] In *Pacific Coast Biscuit Co.*, 32 B.T.A. 39 (1936), the Board held that such expenses were deductible in the year the corporation terminated its existence. But the Treasury consistently refused to follow this and subsequent cases to the same effect. See *Commissioner v. Wayne Coal Mining Co.*, 209 F.2d 152 (C.A.3d, 1954). The Treasury has now announced that it acquiesces in the *Pacific Coast Biscuit* case, and will allow the deduction of liquidation expenses. See 1954–1 Cum.Bull. 6.

Option to Deduct or Capitalize

In a number of situations, Congress has provided optional provisions under which a taxpayer may deduct items otherwise subject to capitalization, or may capitalize items otherwise deductible. These are summarized below:

Circulation expenses. Under sec. 173 of the 1954 Code (first enacted in 1950) expenses to establish, maintain, or increase the circulation of a newspaper, magazine or other periodical are deductible, but may be capitalized at the election of the taxpayer.

Research and experimental expenditures. Sec. 174 is a provision which is new in the 1954 Code. Under it, a taxpayer may deduct research and experimental expenditures (except those for land or depreciable property), or these expenses may be capitalized, or treated as deferred expenses to be deducted over a period of years.[2]

Soil and water conservation expenditures. Another provision which is new in the 1954 Code is that found in sec. 175, under which the expenses of a farmer for soil and water conservation may be deducted, at his election, and with certain qualifications. The Tax Court had allowed the deduction of such expenditures. *J. H. Collingwood,* 20 T.C. 937 (1953).

Carrying charges. For many years the statute has given the taxpayer an option to capitalize taxes and carrying charges with respect to property. This provision is now found in sec. 266 of the 1954 Code. Under it, a taxpayer who bought vacant land for a speculation might prefer to add the taxes and interest to the cost of the land under this provision, particularly if he had no other income during the waiting period.

In *Megibow v. Commissioner,* 218 F.2d 687 (C.A.3d, 1955), the taxpayer was a man who owned his own residence and had paid

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[1] See Weiss, "Income Tax Deductions on Corporate Termination," 9 Tax L.Rev. 490 (1954); "Attorneys' Fees for Partial Liquidation: Business Expense or Capital Asset?" 6 Stanford L.Rev. 368 (1954).

[2] See Alexander, "Research and Experimental Expenditures under the 1954 Code," 10 Tax L.Rev. 549 (1955).

Swanson, "Tax Treatment of Research and Experimentation Expenses," 34 Taxes 541 (1956).

taxes and interest on it. During prior years he had taken the optional standard deduction. In the taxable year, he sold the residence, and sought to add the prior taxes and interest to his basis (thus reducing the gain on the sale) on the ground that they had been capitalized in the previous years. It was held that the option to capitalize carrying charges does not extend to residential property. Is there any basis for this result in the statute? Is it sound?

Trademark and tradename expenditures. By the Act of June 29, 1956, a new sec. 177 was added to the 1954 Code. Under this provision, taxpayers are given an election to treat trademark or trade name expenditures as a deferred expense. In such a case, these expenditures may be deducted ratably over such period of not less than 60 months as may be selected by the taxpayer.

Option to deduct intangible drilling costs of oil and gas wells. Reference should also be made to the provision of sec. 263(c) of the 1954 Code confirming the regulations of the Treasury allowing the deduction of the so-called "intangible drilling costs" of oil and gas wells. Further reference will be made to this matter in connection with the depletion deduction, below.

Is this device of giving the taxpayer an option to deduct or to capitalize certain expenses one which might be extended to other areas of the tax law? In other words, would it be desirable to give taxpayers greater freedom to determine whether various expenditures should be capitalized or deducted, as they might prefer? What difficulties might be encountered?

SPECIAL PROBLEMS

"Reasonable Allowance for Salaries"

Sec. 162(a)(1) of the 1954 Code, and sec. 1.162–7 of the Income Tax Regulations

LONG ISLAND DRUG CO. v. COMMISSIONER

United States Circuit Court of Appeals, Second Circuit, 1940. 111 F.2d 593. Certiorari denied 311 U.S. 680 (1940).

PATTERSON, CIRCUIT JUDGE. Long Island Drug Company, Inc., in its income tax returns for 1931, 1932 and 1933 claimed as deductions from gross income fixed salaries and percentages of profits paid to officers as compensation. The commissioner struck out the deduction of the amounts representing percentages of profits, and the Board of Tax Appeals held with the commissioner.

The company was in the wholesale drug business. Prior to 1930, 50 percent of the stock was owned by Hyman Alkon, Maurice Alkon and Bernard Mindling, the operating officers, in equal shares; the other 50 percent was owned by the parents of Charles Steinberg. The Steinbergs were discontented and brought an action to dissolve the company. Differences were composed by an agreement whereby important changes in merchandising were to be adopted, Charles Steinberg was to become an officer, and the compensation of the four officers was to be fixed at annual set figures and one-half of the profits. Accordingly, the by-laws were amended in 1931 to provide that the president was to receive annual salary of $13,500 and the other three officers $12,500 each, a total of $51,000, and each of the four officers was to have 12½ percent of the profits as additional compensation. For 1931 the 12½ percent of the profits came to $8,000 for each officer; for 1932 and 1933 the percentage came to $2,500 a year in the case of each officer. The company in its tax returns claimed as deductions from gross income the amounts paid the officers, both as fixed salary and as percentage of profits. The commissioner allowed deduction of the fixed salaries. He disallowed deduction of the percentages of profits and gave notice of deficiency of tax for 1931, 1932 and 1933. The company took the case to the Board. It put in evidence the volume of business done by the company, with gross sales ranging from $1,500,000 to $1,800,000 in these years, and many other facts bearing on the character of the business and the services rendered by the officers. It also put in the testimony of two executives in concerns doing a business comparable to the company's; these witnesses gave it as their opinion that the compensation paid to officers was within reasonable bounds. The company never paid dividends on its stock. The Board held that the burden was on the company to prove that the compensation paid was reasonable, and that it had failed to sustain the burden. Decision was in favor of the commissioner.

The deductions were claimed under section 23(a) of the Revenue Act of 1928 and section 23(a) of the Revenue Act of 1932, permitting as a deduction from gross income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered." It may fairly be said in the petitioner's favor that the case is not one where utterly extravagant amounts were paid to officers, in the guise of compensation but without real relation to the measure of their services. *Botany Mills v. United States,* 278 U.S. 282. Nor is it a case where the payments bore a close relation to the stockholdings of the recipients and so might fairly be viewed as dividends for purpose of tax, despite

the name given to the payments. *Twin City Tile & Marble Co. v. Commissioner*, 32 F.2d 229 (C.C.A. 8); *Am-Plus Storage Battery Co. v. Commissioner*, 35 F.2d 167 (C.C.A. 7); *Marble & Shattuck Chair Co. v. Commissioner*, 39 F.2d 393 (C.C.A. 6). Nevertheless, deduction of the amounts paid to the officers under the profit-sharing arrangement was allowable only if those amounts, added to the set salaries, were no more than "reasonable allowance for salaries or other compensation for personal services actually rendered." The reasonableness of the compensation paid was obviously a question of fact and was for the Board to determine. *Wagner & Son v. Commissioner*, 93 F.2d 816 (C.C.A. 9); *H. Levine & Bros. v. Commissioner*, 101 F.2d 391 (C.C.A. 7).

The petitioner says that the Board made no finding that the compensation paid was unreasonably high. It is true that the Board made no such finding in specific terms. What the Board did do was to hold that with the burden on the petitioner to show that the amounts paid were no more than reasonable, the petitioner's evidence was too weak to carry the burden. We regard this as the equivalent of a specific finding by the Board that the compensation paid, over and above the amount allowed by the commissioner as deductible, was unreasonably high. The Board was right in holding that the burden of proving that the claimed deduction was proper was on the petitioner. *Burnet v. Houston*, 283 U.S. 223. The burden was not merely one of going forward with evidence, as the petitioner maintains. And whatever might have been our own views if we had tried the facts, we cannot say that the Board's finding was so clearly out of line with the evidence as to be arbitrary and unfair. It was for the Board to draw inferences, to weigh the evidence and to declare the result. *Helvering v. National Grocery Co.*, 304 U.S. 282.

Affirmed.

Notes

(A) See Baker, "A 'Just Gauge' for Executive Compensation," 22 Harv.Bus.Rev. 75 (1943), based on the facts of the *Long Island Drug* case. See also Wolder, "Facts and Figures on Reasonable Compensation," 24 Taxes 150 (1946).

For consideration of a related problem, see Neuman, "The Tax Liability of the Recipient of a Disallowed Business Deduction," 28 Taxes 811 (1950). In *Smith v. Manning*, 189 F.2d 345 (C.A. 3d, 1951), it was held that the entire amount received by the employee was taxable as income to him even though a portion of the payment was disallowed as a deduction on the ground that it was excessive.

For treatment of general problems in this area, see Sanders, Effects of Taxation on Executives (1951); Hall, Effects of Taxation on Executive Compensation and Retirement Plans (1951).

(B) The general question of the deduction of a reasonable allowance for salaries is treated in "The Deduction of 'A Reasonable Allowance for Salaries'—The Undefined Power of the Commissioner," 56 Harv.L.Rev. 997 (1943). In "New Light on 'A Reasonable Allowance for Salaries'," 59 Harv.L.Rev. 286 (1945), it is argued that the history of the statute shows that it should not properly be construed as authorizing the Commissioner to limit the deduction for salaries actually paid; it was intended, on the contrary, to allow a deduction of a reasonable allowance for salaries in the case of partnerships (taxed under the Revenue Act of 1917, and small family corporations, even though such salaries had not actually been paid.

(C) In determining the reasonableness of the salary, does it matter whether the employee is also a shareholder? In *City Chevrolet Co. v. Commissioner,* 228 F.2d 894 (C.A.4th, 1956), the court held it did. In affirming a Tax Court decision disallowing a salary deduction where officers had a contract for a salary plus 50% of the profits, the court said: "A bonus contract which was reasonable as holding out an incentive to those managing the corporation when its stock was owned by others could well be held unreasonable when the managers themselves became owners of the stock and the question was, not what incentive was needed to call forth their best efforts, but what part of the earnings of the corporation could fairly be paid to them for their services as officers." Is this sound?

(D) A difficult question may be presented where an officer or employee is paid a percentage of the net earnings of a company. In such a case, the amount of the tax depends upon the amount of the deduction for salaries, and the salary payable depends upon the amount of the tax. See Tyson, "Bonus Problems under the Revenue Act of 1938," 67 J. of Accountancy 94 (1939); Norris, "Calculation of Bonuses Based on Earnings after Deduction of State and Federal Taxes," 73 J. of Accountancy 164 (1942); Traver, "Bonus Computations," 81 J. of Accountancy 206 (1946).

"Travelling Expenses .... While Away From Home"

Sec. 162(a)(2) of the 1954 Code, and sec. 1.162–2 of the Income Tax Regulations

In *Commissioner v. Flowers,* 326 U.S. 465 (1946), the taxpayer was a lawyer, residing with his family in Jackson, Mississippi. He was general counsel of a railroad which maintained its headquarters in Mobile, Alabama. His arrangement with the railroad was that he would pay his travelling expenses between Mobile and Jackson, and his living expenses in both places. He sought to deduct these expenses on his federal tax return. The Court held that they were not deductible. The travel expenses were not due to the taxpayer's or the railroad's business but were "occasioned solely by his personal propensities." The Court added that: "Business trips are to be identified in relation to business demands and the traveler's business head-

quarters." Thus "away from home" in sec. 162(a)(2) is in effect construed to mean "away from business headquarters."[1]

Following the *Flowers* case, the courts have tended towards a rather narrow view in cases involving deductions for travelling expenses. The decisions are rather numerous, and present many variations of facts. The following may be given as illustrative:

In *Ney v. United States,* 171 F.2d 449 (C.A.8th, 1948), the taxpayer maintained his residence and his family in Arkansas during the war, while he was employed by the O.P.A. first in Atlanta and then in Washington. He also operated department stores in Arkansas during this period. It was held that his living expenses in Atlanta and Washington were not deductible, the basis of the decision being that these places were in fact his "home" during that period.

A similar result was reached in *Andrews v. Commissioner,* 179 F.2d 502 (C.A.4th, 1950). There the taxpayer kept his family in the family home in Massachusetts, while he went to Washington to work for war agencies. He had no other employment, in Massachusetts or elsewhere, except his government job. He lived in a rented room, and took his meals out. It was held that his expenses in Washington were not deductible.

In *Amoroso v. Commissioner,* 193 F.2d 583 (C.A.1st, 1952), cert. den. 343 U.S. 926 (1952), the taxpayer was a manufacturers' representative in the automobile industry, selling parts and equipment on a commission basis to automotive wholesalers throughout New England. He maintained an office in his house in Milton, Massachusetts. Part of his business was done in Boston, which is about ten miles from Milton. The court held that the amount spent for meals in the greater Boston area was not deductible. Thus "away from home" appears to mean "away from the general area or community of the principal place of business."

Suppose a taxpayer actually has two businesses, one in the city where his residence is, and one in another city. Can he deduct his expenses while attending the business in the other city?

The Treasury has ruled that where an employee has two posts of duty, widely separated, he can deduct the expenses of meals and lodgings at the minor post, but not at the major post. Rev. Rul. 55–604, 1955–2 Cum.Bull. 49. How is this different from the situation in the *Flowers* case, where the taxpayer was a

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[1] "With commendable logic, unaided by judicial gloss, these uninitiated reason that away from home means away from home. They blithely assume that home is the place where they live and raise their family and the place to which they return after the disputed travelling is over. . . . This must be a rude awakening. One can rather imagine such a disillusioned and embittered taxpayer, kissing his wife as he dashes for the morning bus, saying 'Good-bye, my love, I'm going home to the office. I'll be back here for dinner.' " 92 J. of Accountancy 451 (1951).

member of a law firm in Jackson, Mississippi, as well as general counsel of the railroad with headquarters in Mobile, Alabama? Where a teacher in the Providence schools, whose home was in Providence, conducted night courses in Boston, it was held that he could deduct his expenses of travelling to Boston. *Chandler v. Commissioner,* 226 F.2d 467 (C.A.1st, 1955).

O'TOOLE v. COMMISSIONER

United States Court of Appeals, Second Circuit, 1957. 243 F.2d 302.

PER CURIAM. During the years 1950 and 1951 the petitioner maintained a home at Laurelton in Queens County, New York for his wife and children. From April 1, 1950 until after the close of 1951, the petitioner was employed at the President Hotel in Long Beach, New York, about 15 miles from his Laurelton home. The petitioner's employer required him to reside at the hotel during the five or six days per week that he worked there. A room was furnished by the hotel for living accommodations. In filing his tax returns for the years 1950 and 1951 O'Toole entered as deductions the traveling expenses between Laurelton and Long Beach, and the cost of his maintenance at Long Beach. Although the petitioner admitted by stipulation, that part of the deductions, representing railroad fares from Long Beach to Laurelton, should be disallowed, he maintains that expenses of $710 and $800 for meals while employed at Long Beach, during 1950 and 1951 respectively, are deductible under § 23(a)(1)(A) of the Internal Revenue Code of 1939. That section allows as deductions:

"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business * * *"

Upon these facts the Tax Court found that petitioner's home, for the purpose of the statute, was at Long Beach where he was engaged in full time employment and that petitioner's maintaining another home at Laurelton was "immaterial." Thus the expenses were not incurred "while away from home in the pursuit of a trade or business." This finding is clearly correct.

Though we are becoming more and more a nation of city-hoppers and commuters, "traveling expenses" including meals, which are incurred in the suburban and exurban commuters' pattern of life are not deductible if they arise from the taxpayer's choice not to bring his home close to his place of work. "Home" as used in the statute means the taxpayer's principal place of business or employment. The job, not the taxpayer's pattern of living, must

require the traveling expenses. *Carragan v. Commissioner,* 197 F.2d 246, 249 (2 Cir.1952); *Commissioner v. Flowers,* 326 U.S. 465 (1946).

The judgment is, therefore, affirmed.

PEURIFOY v. COMMISSIONER

Supreme Court of the United States, 1958. 358 U.S. 59.

PER CURIAM.

The petitioners were employed as construction workers at a site in Kinston, North Carolina, for continuous periods of 20½ months, 12½ months, and 8½ months, respectively, ending in the year 1953. Each of the petitioners maintained a permanent residence elsewhere in North Carolina. In reporting his adjusted gross income for 1953 each petitioner deducted amounts expended for board and lodging at Kinston during the period of employment there, and for transportation from Kinston to his permanent residence upon leaving that employment. These deductions were disallowed by the respondent. Ensuing Tax Court proceedings resulted in a decision in favor of the petitioners. 27 T.C. 149. The Court of Appeals reversed. 254 F.2d 483. We granted certiorari, 356 U.S. 956, to consider certain questions as to the application of § 23(a)(1)(A) of the Internal Revenue Code of 1939 * raised by the course of decisions in the lower courts since our decision in *Commissioner v. Flowers,* 326 U.S. 465. However, as the case has been presented to us we have found it inappropriate to consider such questions.

The issue is whether the amounts in question constituted allowable deductions under § 23(a)(1)(A). Generally, a taxpayer is entitled to deduct unreimbursed travel expenses under this subsection only when they are required by "the exigencies of business." *Commissioner v. Flowers, supra.* Application of this general rule would require affirmance of the judgment of the Court of Appeals in the present case.

To this rule, however, the Tax Court has engrafted an exception which allows a deduction for expenditures of the type made in this case when the taxpayer's employment is "temporary"

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* "§ 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

"(a) EXPENSES.

"(1) TRADE OR BUSINESS EXPENSES.

"(A) IN GENERAL.

"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; . . . ." (26 U.S.C. (1952 ed.) § 23(a)(1)(A).)

as contrasted with "indefinite" or "indeterminate." Compare *Schurer v. Commissioner*, 3 T.C. 544; *Leach v. Commissioner*, 12 T.C. 20; *Albert v. Commissioner*, 13 T.C. 129, with *Warren v. Commissioner*, 13 T.C. 205; *Whitaker v. Commissioner*, 24 T. C. 750. The respondent does not in the present case challenge the validity of this exception to the general rule.

Resolution of this case as presented to us turns, therefore, upon a narrow question of fact—Was the petitioners' employment "temporary" or "indefinite"? The Tax Court, stating that "each case must be decided upon the basis of its own facts and circumstances," 29 T.C. 157, found that their employment was temporary. The Court of Appeals, also recognizing that the question was "one of fact," held that on the record the Tax Court's finding of temporary employment was "clearly erroneous." 254 F.2d, at 487.

In reviewing the Tax Court's factual determination, the Court of Appeals has made a fair assessment of the record. 26 U.S.C. (Supp.1952 ed.) § 7482; Rule 52(A), Fed.Rules Civ.Proc.; cf. *Universal Camera Corp. v. Labor Board*, 340 U.S. 474. That being so, this Court will not intervene. *Federal Trade Commission v. Standard Oil Co.*, 355 U.S. 396, 400–401; *Labor Board v. Pittsburgh S. S. Co.*, 340 U.S. 498, 502–503.

Affirmed.

MR. JUSTICE DOUGLAS, with whom MR. JUSTICE BLACK and MR. JUSTICE WHITTAKER concur, dissenting.

As *Flowers v. Commissioner of Internal Revenue*[1] indicated, the prerequisites to a deduction for travel expenses under § 23 (a)(1)(A)[2] are threefold: The expenses must be reasonable and necessary,[3] they must be incurred while "away from home," and there must be a "direct connection between the expenditure and the carrying on of the trade or business *of the taxpayer or his employer*." I think the taxpayers in this case have met those conditions and should be allowed the claimed deductions.

The meaning of "home" was expressly left undecided in *Flowers* but is squarely presented in the instant case.[4] I disagree

1 326 U.S. 465.

2 § 162(a) (2) of the 1954 Internal Revenue Code.

3 There is no contention made that the expenses here were not reasonable and necessary.

4 The Court's opinion does not reach this question because it decides the case on a ground not raised by the respondent. See note 6, infra. Instead it affirms the Court of Appeals decision as relying on a factual determination. The Court of Appeals reversed the Tax Court because it thought the latter tribunal had unwarrantedly extended the "exception" to the Flowers case for expenses while "temporarily" away from home. Both courts agreed that taxpayers were away from their actual homes, but the Court of Appeals thought the absence of such duration precluded a deduction. Nowhere in the statute or in Flowers is a distinction made between "temporary" and "indefinite"

with the Commissioner's contention that "home" is synonymous with the situs of the employer's business. Such a construction means that the taxpayer who is forced to travel from place to place to pursue his trade must carry his home on his back regardless of the fact that he maintains his family at an abode which meets all accepted definitions of "home." I do not believe that Congress intended such a harsh result when it provided a deduction for traveling expenses. These construction workers do not have a permanent locus of employment as does the merchant or factory worker. They are required to travel from job to job in order to practice their trade. It would be an intolerable burden for them to uproot their families whenever they change jobs, if those jobs happen to take them to a different locality. When they do not undertake this burden they are living "away from home" [5] for the duration of the term of the jobs.[6]

We have, then, not a question of fact which should be resolved below rather than here. We have a mixed question of law and fact. The facts will turn largely on the resolution of the question of law. The error below was mainly in assuming (albeit silently) a narrow construction of the statutory term "home."

Note

There are comments on this case in 44 Cornell L.Q. 270 (1959), and in 10 J. of Taxation 107 (1959). See also *Claunch v. Commissioner*, 264 F.2d 309 (C.A.5th, 1959).

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absences from home, and in fact such a distinction improperly emphasizes duration of the absence as the determinative factor in deciding where the taxpayer's "home" actually is.

5 This definition of "home" will not permit any taxpayer who lives apart from his family to deduct his maintenance expenses, no matter what the nature of his trade or his employer's business. If the expenses are necessary and appropriate to neither the employer's business nor the employee's trade they are personal expenses under § 24(a)(1) (§ 262 of the 1954 Internal Revenue Code). And of course the facts may show that a taxpayer has in fact abandoned his original "home" as his principal place of residence.

6 The Flowers case does not hold, as the Court suggests, that the deduction is necessarily unavailable if not required by the exigencies of the *employer's* business. In that case a traveling expense deduction was denied a lawyer employed by a railroad who chose to maintain his home in Jackson, Mississippi, although, as the Court found, the permanent place of his business was in Mobile, Alabama. The Court held the expenses of traveling between Jackson and Mobile were not appropriate or necessary to the railroad's business. In the present case, however, the expenses incurred were necessary, not to the business of the contractor for whom the taxpayers worked, but for the taxpayers themselves in order to carry on their chosen trade. Flowers did not decide that, because expenses are not required by the employer's business, they can never be justified as necessary to the employee's trade. The Government does not here contend that the expenses were nondeductible because inappropriate to the trade or business of the employer, the ground of decision in Flowers. Such a contention was not assigned as a reason for disallowance of the deduction nor presented to the courts below.

Suppose a company undertakes a construction project in the country some forty miles from the nearest city. It recruits its workers in the city. They work on the project for several months, but not for an indefinite period. The company pays them their daily transportation and living costs. The Treasury ruled that though these payments were includible in gross income, they were deductible by the employees on their returns. See Rev. Rul. 190, 1953-2 Cum.Bull. 303.

The Treasury's views, particularly with respect to construction workers, are extensively set forth in Rev.Rul. 60-189, 1960-1 Cum.Bull. ——.

On the general question, see "The Meaning of 'Tax Home'—A Study in Judicial Self-Restraint," 1959 U. of Ill.L.Forum 864; "Deduction of Traveling Expenses While 'Away from Home,'" 41 A.B.A.J. 78 (1955); "Living Expenses While 'Away from Home': Business or Personal?" 19 U. of Chi.L.Rev. 534 (1952).

Members of Congress. Members of Congress are usually confronted with the necessity of maintaining two homes. Note the special provision in the last sentence of sec. 162(a). At one time Congress provided for its members a tax-free expense allowance. This was surely objectionable. In 1951, the tax-free allowance was terminated, and the present provision was introduced. This appears to be a reasonable solution of a genuine problem. It may be, though, that others besides Congressmen are under a legitimate necessity of maintaining two or more establishments, and it may be possible to work out a way to meet their need without opening the gates unduly for unwarranted deductions.

Expenses with Respect to Prospective Business or Employment

YORK v. COMMISSIONER

United States Court of Appeals, Fourth Circuit, 1958. 261 F.2d 421.

ALBERT V. BRYAN, DISTRICT JUDGE. Recovery of the income taxes now sought by petitioners York should be decreed. The sum upon which the taxes were assessed was clearly deductible under sec. 23(a), Internal Revenue Code of 1939, as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on . . . [his] trade or business".

The Tax Court reasoned, to the contrary, that the sum in question—an expenditure for the cost of an expert survey to determine the potentiality of nearby land for industrial development—

could not be an operating cost in the taxpayer's business, because his business was residential and commercial real estate, while the outlay related to industrial real estate, and hence was an exploratory expenditure to determine whether he should venture into a new line of business. This conclusion is premised on findings we think clearly erroneous and upon an application of the tax statute we think mistaken.

During the tax year here involved, 1952, and in years prior taxpayer York (his wife now petitioning only because she had joined in the tax return) was engaged in and about Raleigh, North Carolina in the development, management and improvement of real estate generally, but not including industrial properties. Between 1945 and 1952, individually and as an officer of his operating corporation, he quite successfully developed and promoted Cameron Village, in Raleigh, consisting of some 560 rental apartment units surrounding a shopping center of 53 retail commercial outlets occupying some 425,000 square feet of ground.

Because of this success in Cameron Village he was solicited by an officer of Raleigh Development Center to take over the direction of the affairs of that corporation, which had been organized to promote the industrial development of Raleigh and, especially, RDC's acreage there. A percentage stock interest in the corporation, plus a commission on such land dispositions as he might effect was proposed as his compensation. Aware of his inexperience in purely industrial land, he conditioned his acceptance of the proffered employment upon the procurement of an expert survey of the industrial possibilities of this land.

For this purpose he insisted upon the employment of a reputable and generally accepted institute of research, one which he had retained in preparation for the Cameron Village enterprise. This organization had a division for industrial studies and a like advisory council for community builders. Previously the taxpayer had been counseled by the latter; now he engaged the other council. The upshot was that the institute, carefully considering the factors bearing on the area, reported favorably upon its suitability for industry. RDC and York having originally agreed to divide equally the fee of the institute, taxpayer in 1952 paid his share, amounting to $5000, the deduction now claimed.

True, taxpayer never closed the agreement with RDC, but other acts of the taxpayer demonstrate, as emphatically as would have his acceptance of employment from RDC, that the institute's report was a current business expense. In 1952, after the institute had reported, the taxpayer bought one half of the capital stock of Raleigh Development, and from that time on, in 1952 and subsequent years, the taxpayer otherwise dealt actively in industrial sites, obviously adopting and applying his advisor's judgment in his work.

Before 1952 his activities had included, admittedly, the handling not only of residential but of commercial real estate as well, and both in considerable magnitude. Obviously the divergency between concentrated commercial development and industrial development is neither wide nor radical. Indeed, the line of demarcation between them is obscure. Taxpayer's attention to industrial land in 1952 was but the cultivation of a sector already within the compass of his field. The activity was still intramural—it could not, under the evidence, be classed as a new pursuit, apart from his general occupation. The two were one in his vocation. In taking the opposite view, the Tax Court breaks with the intendment of the statute and is not supported by *McDonald v. Commissioner,* 1944, 323 U.S. 57, or the other authorities cited by the appellee.

Again, the fee paid to the institute was clearly an "ordinary and necessary" business expense. Because earlier it had justified itself in Cameron Village, the taxpayer was warranted in considering it worthwhile whether or no the RDC proposition materialized. Actually, the payment was for professional consultation and advice on a subject well within the calling of the taxpayer. That another shared the total cost did not alter its character; that was but an economy. Here, as well, we feel the Tax Court cannot be sustained. Its order must be overturned and the deduction allowed.

Reversed.

Notes

(A) Note the provision of sec. 1.212–1(f) of the Income Tax Regulations, which disallows the deduction of "expenses such as those paid or incurred in seeking employment or in placing oneself in a position to begin rendering personal services for compensation." In Rev.Rul. 60–158, 1960–1 Cum.Bull. ——, the Treasury ruled that fees paid to an employment agency are not deductible. But a few weeks later, it revoked this ruling, and announced that it would allow the deduction of fees paid to employment agencies for securing employment. Rev.Rul. 60–223, 1960–1 Cum.Bull. ——.

Compare *Morton Frank,* 20 T.C. 511 (1953), where travel and legal expenses incurred in an attempt to find and purchase a business were disallowed. See also Rev.Rul. 55–442, 1955–2 Cum.Bull. 529. For general discussion, see Fleischer, "The Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment," 14 Tax L.Rev. 567 (1959).

(B) In *United States v. Woodall,* 255 F.2d 370 (C.A.10th, 1958), cert. den. 358 U.S. 824 (1958), it appeared that a man who lived in Dallas, Texas, took a new job in Albuquerque, New Mexico. The contract of employment provided that the employer would reimburse the taxpayer for the expenses of moving himself and his family from Dallas to Albuquerque. The court held that the amount so received was income, and that the expenses of

moving were not deductible. This was put on the ground that the expenses were essentially personal, being incurred in connection with taking up the employment, and not as a part of the employment activity itself.

Public Policy and Illegality

COMMISSIONER v. SULLIVAN

Supreme Court of the United States, 1958. 356 U.S. 27.

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

The question is whether amounts expended to lease premises and hire employees for the conduct of alleged illegal gambling enterprises are deductible as ordinary and necessary business expenses within the meaning of § 23(a)(i)(A) of the Internal Revenue Code of 1939.[1]

The taxpayers received income from bookmaking establishments in Chicago, Ill. The Tax Court found that these enterprises were illegal under Illinois law,[2] that the acts performed by the employees constituted violations of that law, and that the payment of rent for the use of the premises for the purpose of bookmaking was also illegal under that law. The Tax Court accordingly held that the amount paid for wages and for rent could not be deducted from gross income since those deductions were for expenditures made in connection with illegal acts. 15 CCH TC Mem. Dec. 23, 25 T.C. 513. The Court of Appeals reversed, 241 F.2d 46, 242 F.2d 558, on the basis of its prior decision in *Commissioner v. Doyle,* 231 F.2d 635. The case is here on a petition for certiorari, 354 U.S. 920, for consideration in connection with the companion cases *Hoover Motor Express Co. v. United States,* 356 U.S. 38, and *Tank Truck Rentals, Inc., v. Commissioner,* 356 U.S. 30, decided this day.

Deductions are a matter of grace and Congress can, of course, disallow them as it chooses. At times the policy to disallow expenses in connection with certain condemned activities is clear. It was made so by the Regulations in *Textile Mills Corp. v. Commissioner,* 314 U.S. 326. Any inference of disapproval of these expenses as deductions is absent here. The Regulations, indeed,

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1 Section 23(a)(i)(A) provides:

"In computing net income there shall be allowed as deductions:

. . . .

"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; . . . and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." 56 Stat. 819, 26 U.S.C. § 23(a)(i)(A).

2 Ill.Rev.Stats., 1945, c. 38, § 336.

point the other way, for they make the federal excise tax on wagers deductible as an ordinary and necessary business expense.[3] This seems to us to be recognition of a gambling enterprise as a business for federal tax purposes. The policy that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to allow the normal deductions of the rent and wages necessary to operate it. We said in *Commissioner v. Heininger*, 320 U.S. 467, 474, that the "fact that an expenditure bears a remote relation to an illegal act" does not make it nondeductible. And see *Lilly v. Commissioner,* 343 U.S. 90. If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it. The amounts paid as wages to employees and to the landlord as rent are "ordinary and necessary expenses" in the accepted meaning of the words. That is enough to permit the deduction, unless it is clear that the allowance is a device to avoid the consequence of violations of a law, as in *Hoover Motor Express Co. v. United States, supra,* and *Tank Truck Rentals, Inc. v. Commissioner, supra,* or otherwise contravenes the federal policy expressed in a statute or regulation as in *Textile Mills Corp. v. Commissioner, supra.*

Affirmed.

TANK TRUCK RENTALS, INC. v. COMMISSIONER

Supreme Court of the United States, 1958. 356 U.S. 30.

MR. JUSTICE CLARK delivered the opinion of the Court.

In 1951 petitioner Tank Truck Rentals paid several hundred fines imposed on it and its drivers for violations of state maximum weight laws. This case involves the deductibility of those payments as "ordinary and necessary" business expenses under § 23(a)(1)(A) of the Internal Revenue Code of 1939.[1] Prior

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[3] Regulations 118, § 39.23(a) 1: Rev.Rul. 54–219, 1954–1 Cum.Bull. 51:

"The Federal excise tax on wagers under section 3285(d) of the Internal Revenue Code and the special tax under section 3290 of the Code paid by persons engaged in receiving wagers are deductible, for Federal income tax purposes, as ordinary and necessary business expenses under section 23(a) of the Internal Revenue Code, provided the taxpayer is engaged in the business of accepting wagers or conducting wagering pools or lotteries, or is engaged in receiving wagers for or on behalf of any person liable for the tax under section 3285(d) of the Code."

[1] "SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

"(a) EXPENSES.—

"(1) TRADE OR BUSINESS EXPENSES.—

"(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." 53 Stat. 12, as amended, 56 Stat. 819.

to 1950 the Commissioner had permitted such deductions,[2] but a change of policy that year[3] caused petitioner's expenditures to be disallowed. The Tax Court, reasoning that allowance of the deduction would frustrate sharply defined state policy expressed in the maximum weight laws, upheld the Commissioner. 26 T.C. 427. The Court of Appeals affirmed on the same ground, 242 F.2d 14, and we granted certiorari. 354 U.S. 920 (1957). In our view, the deductions properly were disallowed.

Petitioner, a Pennsylvania corporation, owns a fleet of tank trucks which it leases, with drivers, to motor carriers for transportation of bulk liquids. The lessees operate the trucks throughout Pennsylvania and the surrounding States of New Jersey, Ohio, Delaware, West Virginia, and Maryland, with nearly all the shipments originating or terminating in Pennsylvania. In 1951, the tax year in question, each of these States imposed maximum weight limits for motor vehicles operating on its highways.[4] Pennsylvania restricted truckers to 45,000 pounds, however, while the other States through which petitioner operated allowed maximum weights approximating 60,000 pounds. It is uncontested that trucking operations were so hindered by this situation that neither petitioner nor other bulk liquid truckers could operate profitably and also observe the Pennsylvania law. Petitioner's equipment consisted largely of 4,500–5,000 gallon tanks, and the industry rate structure generally was predicated on fully loaded use of equipment of that capacity. Yet only one of the commonly carried liquids weighed little enough that a fully loaded truck could satisfy the Pennsylvania statute. Operation of partially loaded trucks, however, not only would have created safety hazards, but also would have been economically impossible for any carrier so long as the rest of the industry continued capacity loading. And the industry as a whole could not operate on a partial load basis without driving shippers to competing forms of transportation. The only other alternative, use of smaller tanks, also was commercially impracticable, not only because of initial replacement costs but even more so because of reduced revenue and increased operating expense, since the rates charged were based on the number of gallons transported per mile.

2 IT:P:2—WTL; 5 CCH 1950 Fed.Tax Rep. ¶ 6134.

3 1951—1 Cum.Bull. 15.

4 Delaware, Del.Laws 1947, c. 86, § 2; Maryland, Flack's Md.Ann.Code, 1939 (Supp.1947), Art. 66½, § 254, and Flack's Md.Ann.Code, 1951, Art. 66½, § 278; New Jersey, N.J.Rev.Stat., 1937, 39:3–84; Ohio, Page's Ohio Gen.Code Ann., 1938 (Supp.1952), § 7248–1; Pennsylvania, Purdon's Pa.Stat.Ann., 1953, Tit. 75, § 453; West Virginia, W.Va.Code Ann., 1949, § 1546, and 1953 Supp., § 1721 (463).

Confronted by this dilemma, the industry deliberately operated its trucks overweight in Pennsylvania in the hope, and at the calculated risk, of escaping the notice of the state and local police. This conduct also constituted willful violations in New Jersey, for reciprocity provisions of the New Jersey statute subjected trucks registered in Pennsylvania to Pennsylvania weight restrictions while traveling in New Jersey.[5] In the remainder of the States in which petitioner operated, it suffered overweight fines for several unintentional violations, such as those caused by temperature changes in transit. During the tax year 1951, petitioner paid a total of $41,060.84 in fines and costs for 718 willful and 28 innocent violations. Deduction of that amount in petitioner's 1951 tax return was disallowed by the Commissioner.

It is clear that the Congress intended the income tax laws "to tax earnings and profits less expenses and losses," *Higgins v. Smith,* 308 U.S. 473, 477 (1940), carrying out a broad basic policy of taxing "net, not . . . gross, income . . ." *McDonald v. Commissioner,* 323 U.S. 57, 66–67 (1944). Equally well established is the rule that deductibility under § 23(a)(1)(A) is limited to expenses that are both ordinary and necessary to carrying on the taxpayer's business. *Deputy v. duPont,* 308 U.S. 488, 497 (1940). A finding of "necessity" cannot be made, however, if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof. *Commissioner v. Heininger,* 320 U.S. 467, 473 (1943); see *Lilly v. Commissioner,* 343 U.S. 90, 97 (1952). This rule was foreshadowed in *Textile Mills Securities Corp. v. Commissioner,* 314 U.S. 326 (1941), where the Court, finding no congressional intent to the contrary, upheld the validity of an income tax regulation reflecting an administrative distinction "between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction." 314 U.S., at 339. Significant reference was made in *Heininger* to the very situation now before us; the Court stated, "Where a taxpayer has violated a federal or a state statute and incurred a fine or penalty he has not been permitted a tax deduction for its payment." 320 U.S., at 473.

Here we are concerned with the policy of several States "evidenced" by penal statutes enacted to protect their highways from damage and to insure the safety of all persons using them.[6] Petitioner and its drivers have violated these laws and have been

[5] N.J.Rev.Stat., 1937 (Cum.Supp.1948–1950), 39:3–84.3.

[6] Because state policy in this case was evidenced by specific legislation, it is unnecessary to decide whether the requisite "governmental declaration" might exist other than in an Act of the legislature. See Schwartz, Business Expenses Contrary To Public Policy, 8 Tax L.Rev. 241, 248.

sentenced to pay the fines here claimed as income tax deductions.[7] It is clear that assessment of the fines was punitive action and not a mere toll for use of the highways: the fines occurred only in the exceptional instance when the overweight run was detected by the police. Petitioner's failure to comply with the state laws obviously was based on a balancing of the cost of compliance against the chance of detection. Such a course cannot be sanctioned, for judicial deference to state action requires, whenever possible, that a State not be thwarted in its policy. We will not presume that the Congress, in allowing deductions for income tax purposes, intended to encourage a business enterprise to violate the declared policy of a State. To allow the deduction sought here would but encourage continued violations of state law by increasing the odds in favor of noncompliance. This could only tend to destroy the effectiveness of the State's maximum weight laws.

This is not to say that the rule as to frustration of sharply defined national or state policies is to be viewed or applied in any absolute sense. "It has never been thought . . . that the mere fact that an expenditure bears a remote relation to an illegal act makes it nondeductible." *Commissioner v. Heininger, supra,* at 474. Although each case must turn on its own facts, *Jerry Rossman Corp. v. Commissioner,* 175 F.2d 711, 713, the test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction. The flexibility of such a standard is necessary if we are to accommodate both the congressional intent to tax only net income, and the presumption against congressional intent to encourage violation of declared public policy.

Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. See *Boyle, Flagg & Seaman, Inc., v. Commissioner,* 25 T.C. 43. If the expenditure is not itself an illegal act, but rather the payment of a penalty imposed by the State because of such an act, as in the present case, the frustration attendant upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance. Deduction of fines and penalties uniformly has been held to frustrate state

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7 Unlike the rest of the States, Pennsylvania imposed the fines on the driver rather than the owner of the trucks. In each instance, however, the driver was petitioner's employee, and petitioner paid the fines as a matter of course, being bound to do so by its collective bargaining agreement with the union representing the drivers.

policy in severe and direct fashion by reducing the "sting" of the penalty prescribed by the state legislature.[8]

There is no merit to petitioner's argument that the fines imposed here were not penalties at all, but merely a revenue toll. It is true that the Pennsylvania statute provides for purchase of a single trip permit by an overweighted trucker; that its provision for forcing removal of the excess weight at the discretion of the police authorities apparently was never enforced; and that the fines were devoted by statute to road repair within the municipality or township where the trucker was apprehended. Moreover, the Pennsylvania statute was amended in 1955,[9] raising the maximum weight restriction to 60,000 pounds, making mandatory the removal of the excess, and graduating the amount of the fine by the number of pounds that the truck was overweight. These considerations, however, do not change the fact that the truckers were fined by the State as a penal measure when and if they were apprehended by the police.

Finally, petitioner contends that deduction of the fines at least for the innocent violations will not frustrate state policy. But since the maximum weight statutes make no distinction between innocent and willful violators, state policy is as much thwarted in the one instance as in the other. Petitioner's reliance on *Jerry Rossman Corp. v. Commissioner, supra,* is misplaced. Deductions were allowed the taxpayer in that case for amounts inadvertently collected by him as O.P.A. overcharges and then paid over to the Government, but the allowance was based on the fact that the Administrator, in applying the Act, had differentiated between willful and innocent violators. No such differentiation exists here, either in the application or the literal language of the state maximum weight laws.

Affirmed.

HOOVER MOTOR EXPRESS CO. v. UNITED STATES

Supreme Court of the United States, 1958. 356 U.S. 38.

MR. JUSTICE CLARK delivered the opinion of the Court.

The sole issue here—the deductibility for tax purposes of fines paid by a trucker for *inadvertent* violations of state maximum weight laws—is identical to one of the issues decided today in No. 109, *Tank Truck Rentals, Inc. v. Commissioner,* 356 U.S. 30.

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8 See, e. g., United States v. Jaffray, 97 F.2d 488, aff'd sub nom. on other grounds, United States v. Bertelsen & Petersen Engineering Co., 306 U.S. 276 (1939); Tunnel R. Co. v. Commissioner, 61 F.2d 166; Chicago, R. I. & P. R. Co. v. Commissioner, 47 F.2d 990; Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178; Great Northern R. Co. v. Commissioner, 40 F.2d 372; Davenshire, Inc., v. Commissioner, 12 T.C. 958.

9 Purdon's Pa.Stat.Ann., 1953 (Supp.1957), Tit. 75, § 453.

Most of the overweight fines paid by petitioner during 1951–1953 inclusive, the tax years in question, were incurred in Tennessee and Kentucky, two of the nine States in which petitioner operated. During the relevant period, both Tennessee and Kentucky imposed maximum weight limitations of 42,000 pounds over-all and 18,000 pounds per axle, considerably less than those in the other seven States. Petitioner's fines resulted largely from violations of the axle weight limits rather than violations in over-all truck weight. The District Court found that such violations usually occurred because of a shifting of the freight load during transit.

After paying the taxes imposed, petitioner sued in the District Court for a refund, claiming that no frustration of state policy would result from allowance of the deductions because (1) the violations had not been willful, and (2) all reasonable precautions had been taken to avoid the violations. The District Court held that even if petitioner had acted innocently and had taken all reasonable precautions, allowance of the deductions would frustrate clearly defined state policy. Judgment was entered for the Commissioner, 135 F.Supp. 818, and the Court of Appeals affirmed on the same reasoning. 241 F.2d 459. We granted certiorari, 354 U.S. 920 (1957), in conjunction with the grant in *Tank Truck Rentals, Inc. v. Commissioner, supra,* and *Commissioner v. Sullivan,* 356 U.S. 27, both decided today.

Wholly apart from possible frustration of state policy, it does not appear that payment of the fines in question was "necessary" to the operation of petitioner's business. This, of course, prevents any deduction. *Deputy v. duPont,* 308 U.S. 488 (1940). The violations usually resulted from a shifting of the load during transit, but there is nothing in the record to indicate that the shifting could not have been controlled merely by tying down the load or compartmentalizing the trucks. Other violations occurred because petitioner relied on the weight stated in the bill of lading when picking up goods in small communities having no weighing facilities. It would seem that this situation could have been alleviated by carrying a scale in the truck.

Even assuming that petitioner acted with all due care and without willful intent, it is clear that allowance of the deduction sought by petitioner would severely and directly frustrate state policy. *Tank Truck Rentals, Inc. v. Commissioner, supra.* As in *Tank Truck,* the statutes involved here do not differentiate between innocent and willful violators.

Affirmed.

Notes

(A) *Lilly v. Commissioner,* 343 U.S. 90 (1952), involved "kickbacks" from opticians to physicians, where the physicians had sent patients to the opticians to have prescriptions for glasses filled. The payments were not "illegal" under the law of North Carolina, but they were against "public policy," and they were "unethical" as far as the physicians were concerned. It was held that the payments could be deducted. See Schwartz, "Business Expenses Contrary to Public Policy: An Evaluation of the *Lilly* Case," 8 Tax L.Rev. 241 (1953).

In *Commissioner v. Heininger,* 320 U.S. 467 (1943), the Court allowed the deduction of attorneys' fees and other legal expenses incurred in an unsuccessful effort to resist a fraud order issued by the Postmaster General.

(B) Suppose the payment is itself illegal, as a bribe to a public officer. Can such payments be deducted if the taxpayer shows that they are "ordinary and necessary"? What about "commercial bribery," such as "kickback" payments made by a seller of goods to the purchasing agent for the buyer? See Rev.Rul. 54–27, 1954–1 Cum.Bull. 44.

In the Technical Amendments Act of 1958, Congress added a specific provision to sec. 162 of the 1954 Code, stating explicitly that bribes or other improper payments to officials or employees of foreign countries are not deductible.

(C) In *Universal Atlas Cement Co.,* 9 T.C. 971 (1947), the taxpayer made a payment in compromise of a criminal prosecution brought by a state for an antitrust law violation. The payment was made without any admission of guilt, and the taxpayer asserted that it was made in order to avoid the expense, and the loss of officers' time, which would be required in order to defend the suit. The Tax Court held that the payment was not deductible.

(D) In *Jerry Rossman Corp. v. Commissioner,* 175 F.2d 711 (C.A.2d, 1949), the taxpayer had made charges to customers which were in excess of war-time ceiling prices. When this was questioned by the Office of Price Administration, the excess payments were paid over to the United States. It was held that the amounts so paid could be deducted on the ground that they were not a penalty, and even if they were, they were not such a penalty as was not deductible as a business expense. *Commissioner v. Pacific Mills,* 207 F.2d 177 (C.A.1st, 1953); Rev.Rul. 54–204, 1954–1 Cum.Bull. 49, *accord.* See Gelfand, "Payments to O.P.A.," 27 Taxes 961 (1949).

Where, however, a federal district court had held in a suit by the O.P.A. administrator that a taxpayer's violation was willful, it was held that this was res judicata, and the payment was not deductible for tax purposes. *Julian Lentin,* 23 T.C. 112 (1954).

(E) For general discussion, see "Public Policy and Federal Income Tax Deductions," 51 Col.L.Rev. 752 (1951); "Deduction of Business Expenses: Illegality and Public Policy," 54 Harv.L. Rev. 852 (1941).

(F) In *Keystone Metal Co. v. Commissioner,* 264 F.2d 561 (C.A.3d, 1959), the court held that a penalty paid for delay in

paying taxes, where the delay was due to contesting the validity of the taxes, was deductible. The court distinguished the *Tank Truck* and *Hoover* cases, and relied on the *Heininger* case. Is this sound? There is a comment in 46 Va.L.Rev. 154 (1960).

"Lobbying"

The Supreme Court has rendered two decisions sharply limiting the deduction of "lobbying" expenses:

In *Textile Mills Securities Corp. v. Commissioner,* 314 U.S. 326 (1941), the Court held, in rather sweeping terms, that legal fees paid in connection with lobbying appearances before Congress cannot be deducted. In reaching this result, the Court relied heavily on a provision of the regulations.

In *Cammarano v. United States,* 358 U.S. 498 (1959), the Court held that expenses incurred by a brewery in opposing an initiative measure before the voters of the State of Washington which would have excluded them from retail business, establishing a State monopoly, were not deductible. The opinion proceeds in broad terms, and reaffirms the position taken in the *Textile Mills* case, and the validity of the Regulation relied on there.

The regulation relied on in these cases has been carried forward into sec. 1.162–15(c) of the Income Tax Regulations.

Is this result wholly sound—as applied to all legislative work by lawyers for example? There would not seem to be any reason why open appearances before a Congressional committee should not be as much a part of legitimate legal practice as similar appearances before a court. Suppose a Congressional committee invites a company to make an appearance in connection with a pending general revision of a tax bill, and the company's lawyer prepares the materials, and perhaps makes the appearance. Can the expenses of this appearance be deducted?

See "Deducting Business Expenses Designed to Influence Governmental Policy as 'Ordinary and Necessary': Cammarano v. United States and a Bit Beyond," 69 Yale L.J. 1017 (1960); "Deductibility of Expenses to Influence Legislation," 46 Va. L.Rev. 112 (1960); Sharp, "Reflections on the Disallowance of Income Tax Deductions for Lobbying Expenditures," 39 B.U.L. Rev. 365 (1959).[1]

Expenses for the Production of Income

Sec. 212 of the 1954 Code, and sec. 1.212–1 of the Income Tax Regulations

For many years, the statute in terms allowed the deduction only of expenses incurred in a trade or business. As a matter of practice, expenses were quite freely allowed when they arose in

[1] For discussions of the problem prior to the Cammarano decision, see "Income Tax Disadvantages of Political Activities," 57 Col.L.Rev. 273, 281 (1957); Spiegel, "Deductibility of Lobbying, Initiative and Referendum Expenses: A Problem for Congressional Consideration," 45 Calif.L.Rev. 1 (1957); "Tax Treatment of Lobbying Expenses and Contributions," 67 Harv.L.Rev. 1408 (1954). See also Sunderland, "The Taxation of Free Speech," 26 U. of Chi.L. Rev. 109 (1958).

connection with the production of income, even though not in a trade or business. Examples were investment expenses, including the cost of operating real estate which a person (engaged in some other trade or business) might own for investment.

However, in *Higgins v. Commissioner,* 312 U.S. 212 (1941), the court held that investment expenses were not deductible as ordinary business expenses. The case was a rather unusual one. The taxpayer was immensely wealthy. He spent his time on the Riviera, and maintained a large office in New York to handle his securities and his real estate. The court felt that these expenses were in essence personal, designed primarily to enable him to lead a carefree existence elsewhere. But the decision was equally applicable to the investment expenses of persons with more modest interests.

The result was the addition of a new sec. 23(a)(2) to the old Internal Revenue Code by the Revenue Act of 1942. This is the provision which is now found, with some modifications, in sec. 212 of the 1954 Code.

For general discussion, see Nahstoll, "Non-trade and Non-business Expense Deductions," 46 Mich.L.Rev. 1015 (1948); Brodsky and McKibben, "Deduction of Non-trade or Non-business Expenses," 2 Tax L.Rev. 39 (1946); Seghers, "Deductibility of Investors' Expenses under Section 23(a)(2) of the Internal Revenue Code," 81 J. of Accountancy 130 (1946).

NAYLOR v. COMMISSIONER

United States Court of Appeals, Fifth Circuit, 1953. 203 F.2d 346.

HOLMES, CIRCUIT JUDGE. This proceeding involves an alleged deficiency in petitioner's income taxes for the year 1946. The question presented is whether a fee of $28,000 paid an attorney for his services in September, 1946, was deductible from gross income as a non-business expense under section 23(a)(2) of the Internal Revenue Code, 26 U.S.C., or was allowable to petitioner only as a selling expense in his computation of capital gain realized on the sale of his corporate stock.

The pertinent facts are undisputed and largely stipulated. Briefly stated, they are as follows: In August, 1946, the taxpayer owned 2000 shares of stock of the Lane Drug Stores, Inc., which it had offered to sell to the Interstate Drugs, Inc., hereinafter refered to as Interstate. The offer to sell was in the form of an option given Interstate by petitioner in a contract between the parties, dated June 1, 1942. By letter of August 23, 1946, the Interstate Company advised petitioner that in view of its agreement to sell all the stock of Lane Drug Stores, Inc., it would be necessary for it to repurchase at "the book value as of July 31, 1946"

the shares held by petitioner. Subsequently, by letter dated September 4, 1946, the Company gave petitioner formal notice of the exercise of its option. The option agreement provided that Interstate should pay for such shares so purchased the net asset value thereof as shown by the books of Lane Drug Stores, Inc., on the last day of the month preceding the date on which the purchase or sale was consummated.

The exercise on September 4, 1946, by the Company of its undisputed right to purchase petitioner's stock effectively converted the agreement of June 1, 1942, into a binding contract of sale, since it constituted an acceptance of petitioner's outstanding offer to sell; but a dispute arose between the parties as to the net asset value of the shares as shown by the books of Lane Drug Stores on the last day of the month preceding the date on which the purchase or sale was consummated. The option agreement repeatedly referred to the purchase or sale as being "consummated" when the party formally exercised its right to purchase said stock.

Since the sale was consummated except as to the delivery of the stock and the payment of the purchase price, the petitioner did not need and did not employ a broker to sell his stock, but employed a lawyer to negotiate, and if necessary to sue, for the purchase money due him under the contract. The Interstate Company had previously given notice to the petitioner that it was exercising its option to buy this stock for $440,000, the asserted option price. The amount paid his attorney by petitioner was for services leading to the petitioner receiving $580,000 for delivering his stock to the purchaser under the option. This was $140,000 above the price at which the Company had purported to exercise its option.

There was no dispute about the title to the stock or petitioner's duty to deliver it. The controversy was over the amount due him upon delivery thereof. The situation called for the services of an attorney to collect the proceeds of a sale of a capital asset. Petitioner's attorney was employed after an enforceable contract of sale existed. The gain realized by petitioner upon the disposition of his stock was income collected within the meaning of Section 23(a)(2) of the Internal Revenue Code. *Commissioner of Internal Revenue v. Heininger,* 320 U.S. 467; *Redmond v. Sinclair Refining Co.,* 204 Ga. 699(7), 51 S.E.2d 409; *Crawford v. Baker,* 207 Ga. 56, 61, 60 S.E.2d 146; Williston on Contracts, Rev.Ed. (1936), Sec. 25; 49 Am.Jur., Specific Performance, Sec. 131; 22 A.L.R. 1032, 1041(c); 13 A.L.R. 920, 926(c). Cf. *Heller v. Commissioner,* 9 Cir., 147 F.2d 376, certiorari denied, 325 U.S. 868.

Reversed, and remanded to the Tax Court for further proceedings not inconsistent with this opinion.

Notes

(A) Cf. *Bowers v. Lumpkin*, 140 F.2d 927 (C.C.A.4th, 1944), where the taxpayer had purchased certain stock. A suit was brought to invalidate the sale. The taxpayer retained counsel to defend the suit and eventually her ownership was upheld. The court held that the legal expenses were incurred to defend or protect the title to the taxpayer's property which were not deductible. They represented a capital charge which should be added to the cost of the property.

See also *O'Malley v. Yost*, 189 F.2d 331 (C.A.8th, 1951), where it appeared that a husband, whose wife was estranged, wanted to sell certain real property. In order to get the wife's consent to the conveyance, he had to make a substantial payment to her. It was held that this amount could not be deducted as an expense. The court said that the payment was made to perfect the husband's title to the land. Apparently it would be taken into account in determining gain or loss on the sale.

(B) Expenses, including attorney's fees, in connection with a divorce would seem to be personal expenditures, and not deductible under sec. 212, or otherwise. In several cases, however, taxpayers' counsel have been able to persuade appellate courts that attorney's fees paid in connection with a divorce were paid for the purpose of preserving to the taxpayer certain property which was important to him, and that the fees so paid were deductible as amounts paid for the preservation of property held for the production of income within sec. 212. *Owens v. Commissioner*, 273 F.2d 251 (C.A.5th, 1959); *McMurtry v. United States*, 132 Ct.Cls. 148, 132 F.Supp. 114 (1955); *Bowers v. Commissioner*, 243 F.2d 904 (C.A.6th, 1957); *Baer v. Commissioner*, 196 F.2d 646 (C.A.8th, 1952). But see *Harris v. United States*, 275 F.2d 238 (C.A.9th, 1960).

Can this result be justified? If a person is sued for a tort and spends money for counsel fees to protect his property against an adverse judgment, can this expense be deducted?

(C) *Expenses of tax litigation.* A good deal of controversy developed over the question whether the expenses of tax litigation, including counsel fees, were deductible as expenses for the production of income, or for the conservation and management of property held for the production of income. In *Trust of Bingham v. Commissioner*, 325 U.S. 365 (1945), the Court held that legal fees incurred by the trustees of a trust for tax advice, and for other purposes, were deductible. The Tax Court held that this decision applied generally to legal expenses in income tax matters, and this view was formally accepted by the Treasury. T.D. 5513, 1946–1 Cum.Bull. 61, amending sec. 29.23(a)-(15) (b) of Regulations 111.

However, in *Lykes v. United States*, 343 U.S. 118 (1952), the court held that legal expenses incurred in resisting a gift tax deficiency were not deductible.

In the Internal Revenue Code of 1954, the statutory provision in sec. 212 contains a new clause allowing the deduction of expenses "in connection with the determination, collection, or re-

fund of any tax." This is in very broad terms and clearly overrules the *Lykes* case for 1954 and later years. See also paragraph (*l*) of sec. 1.212–1 of the Income Tax Regulations.

Interest

Sec. 163 of the 1954 Code; also secs. 264 and 265(2); and secs. 1.163–1 through 1.163–2 of the Income Tax Regulations

WETTERAU GROCER COMPANY, INC. v. COMMISSIONER

Court of Appeals, Eighth Circuit, 1950. 179 F.2d 158.

GARDNER, CHIEF JUDGE, delivered the opinion of the Court.

This matter is before us on petition to review a decision of the Tax Court which sustained the Commissioner in his determination of a deficiency in taxpayer's income for the years 1943 and 1944 in the amount of $6200.40.

Taxpayer is a corporation organized under the laws of the State of Missouri, where it is engaged in the wholesale grocery business. Its stock has at all times been closely held by the members of the Wetterau family. In 1924 it paid a stock dividend to its common stockholders in the form of 500 shares of preferred stock having a par value of $100.00 a share. On March 31, 1939, at a special stockholder's meeting, at which all the stockholders including those holding the outstanding preferred stock of the company were present in person, a plan was unanimously adopted authorizing the company to issue an aggregate of $100,000.00 in Series A, one to seven per cent, fifty year debenture notes, the rate of interest to be at the discretion of the directors according to earnings payable on the 30th day of June and the 31st day of December in each year, "to be subordinate to the claims of general creditors, but superior to the claims of stockholders, callable at par, with accrued interest, after five years, on any interest date, upon thirty days' written notice, the notes not to be sold or assigned by the holders without notice to the company and ample opportunity to redeem and to exchange the outstanding preferred stock for a like amount of said notes." Pursuant to the action taken, notes in the amount of $50,000.00 were issued and were exchanged for the entire outstanding preferred stock. At the same meeting of stockholders it was resolved that "the outstanding preferred stock of the company be retired as of March 31st, 1939, with interest adjusted from January 1st, 1939, by exchanging therefor a like amount of Series A debenture notes, with the consent of the preferred stockholder . . . ." The stockholders also authorized the issuance of certain Series B five year debenture notes but as they are not here involved no further

reference need be made to them. The $50,000.00 authorized balance of Series A debenture notes has never been issued. During each of the years 1943 and 1944 the Board of Directors voted to pay seven per cent on these outstanding $50,000.00 Series A debenture notes and payment was accordingly so made. The taxpayer deducted the amount of the interest so paid for the years 1943 and 1944. The Commissioner disallowed the item as a deductible expense and the Tax Court sustained the Commissioner and from its decision taxpayer petitions for review.

The issue is a very narrow one and may be stated as follows: whether the amount paid by the taxpayer during the years 1943 and 1944 to the holders of the debenture notes constituted dividends or constituted interest paid and hence deductible under Section 23(b) of the Internal Revenue Code. No all-comprehensive rule has as yet been established governing all conceivable situations but each case must turn on its own particular facts. *Helvering v. Richmond F. & P. R. Co.*, 4 Cir., 90 F.2d 971. Deductions are a matter of legislative grace allowable only where there is clear provision therefor and it is incumbent upon the taxpayer to establish by a preponderance of the evidence that the holders of these Series A notes were creditors and that the payment made by the taxpayer was in fact interest upon an indebtedness. Interest, within the meaning of Section 23(b) has been defined as "the amount which one has contracted to pay for the use of borrowed money." *Deputy, Admx. v. duPont,* 308 U.S. 488; *Equitable Life Assur. Society v. Commissioner,* 321 U.S. 560. These notes were not issued for borrowed money. They represented no new contribution to capital. They were exchanged for outstanding preferred stock which had been issued as a stock dividend to the common stockholders. The holders of these notes were the common stockholders and these notes simply supplanted the outstanding preferred stock. There is no apparent business advantage to the taxpayer unless by this transaction it will be enabled to deduct as a necessary expense the amount paid as interest on these notes. Had the amount been paid as dividends on the preferred stock, confessedly no deduction could be had.

It is to be noted that the payment of interest was at the discretion of the directors and dependent upon the company's earnings. This is not a characteristic of an interest obligation but is a characteristic of the duty to pay dividends. The amount of interest is not fixed by the note except that a maximum amount is fixed and the notes, like preferred stock, were subordinate to the claims of general creditors. The amount of the payment of so-called interest is not definite but dependent upon the net earnings. The attribute of a creditor relationship—the right to share on an equal basis with other creditors of the same class—is wanting. It is to be noted too that the notes were not negotiable; in fact,

they could be transferred only upon giving written notice and upon first giving an opportunity to the taxpayer to redeem the notes. The notes had practically all the characteristics of the preferred stock which they supplanted.

In these tax matters substance rather than form must be regarded and we agree with the Tax Court that these payments had the attributes of dividends rather than of interest and its decision is therefore affirmed.

Notes

(A) As this case illustrates, the "interest" which is deductible under sec. 163 is not merely a matter of nomenclature.[1] Cf. *John Kelley Co. v. Commissioner,* 326 U.S. 521 (1946).

Indeed, cases are occasionally encountered in which "dividends" payable on "stock" are held to be deductible as interest payments. This was allowed with respect to payments by a railroad on its "guaranteed stock," which were payable whether earned or not. *Helvering v. Richmond, F. and P. R. R. Co.,* 90 F. 2d 971 (C.C.A.4th, 1937); *United States v. South Georgia Ry.,* 107 F.2d 3 (C.C.A.5th, 1939). See also *Choctaw, Inc.,* T.C. Memo., Dec. 9, 1953.

(B) May a corporation deduct as interest payments which it makes on its "income bonds," where the amounts are payable only out of income, and are not cumulative? How do such payments differ from dividends? *Commissioner v. Schmoll Fils Associated, Inc.,* 110 F.2d 611 (C.C.A.2d, 1940).

(C) A subsidiary corporation, wholly owned by its parent, declares a dividend to its parent payable in bonds of the subsidiary. The bonds are in terms a fixed obligation. May the subsidiary deduct the interest it pays? *Kraft Foods Co. v. Commissioner,* 232 F.2d 118 (C.A.2d, 1956).

(D) A penalty payment made by a taxpayer to his mortgagee in order to obtain release from the mortgage by paying it before its due date has been held to be "interest," and deductible even when the payment is made with respect to residential property. Rev.Rul. 57–198, 1957–1 Cum.Bull. 94, revoking Rev.Rul. 55–12, 1955–1 Cum.Bull. 259.

"Thin Incorporation"

(E) Suppose that a corporation is organized with a very small amount of stock and a large amount of bonds. In *Swoby Corp.,* 9 T.C. 887 (1947), land was transferred to a corporation, which then issued its entire stock of $200 total par value and $250,000 of income debentures. It was held that the corporation was not entitled to any deduction for interest paid; the debentures were in effect regarded as representing the equity ownership in the corporation and were thus the equivalent of stock.

[1] See "Deductions for Interest Under the Federal Income Tax," 55 Harv.L. Rev. 1189 (1942); "Deductibility of Interest for Income Tax Purposes," 90 U. of Pa.L.Rev. 730 (1942).

What is the maximum proportion of debt in relation to stock which will be safe and will allow an interest deduction? Is it one-third debt—or two-thirds debts—or what?

Since the decision of the Supreme Court in *John Kelly Co. v. Commissioner,* 326 U.S. 521 (1946), a ratio of debt to equity of four to one has generally been considered "safe." However, in *Royalty Service Corp. v. United States,* 178 F.Supp. 216 (D.Mont. 1959), there was $150,000 of debt and $3 was paid for all the common stock, a ratio of 50,000 to 1. Under the special circumstances of that case, it was held that interest on the debt was deductible. It would seem prudent, though, not to try to push things quite so far. There is particularly likely to be trouble if the debt issued is considerably in excess of the value of the assets transferred. See *Hoguet Real Estate Corp.,* 30 T.C. 580 (1958).[2]

(F) Is there a discrimination against equity capital in the allowance of a deduction for interest when no deduction is allowed for dividends paid? Is this desirable? How would it be feasible to eliminate it? See Groves, Production, Jobs and Taxes 18–49 (1944). Would it be desirable to allow a deduction for dividends paid, as well as for interest? Would this be a better plan than the credit for dividends which was granted to individuals by secs. 116 and 34 of the 1954 Code? What would be the economic consequences if dividends were allowed as a deduction in determining corporate taxable income?

See Molloy, "The Ambiguous Tax Nature of the Various Costs of Borrowing Capital," 11 Tax L.Rev. 373 (1956).

Ordinarily a person cannot deduct interest unless he pays it as interest, and pays it on his own indebtedness (or at least on indebtedness which is a lien on property of which he is owner).

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2 For current consideration of this problem, see Caplin, "The Caloric Count of a Thin Incorporation," 43 Marquette L.Rev. 31 (1959); "Thin Incorporation: The Major Tests of Debt or Equity Financing," 1959 Wash.U.L.Q. 433; "The Thin Incorporation Problem: Are the Courts Fighting a Tar Baby?" 5 U.C.L.A.L.Rev. 275 (1958); Kramer, "The Thin Incorporation Problem Today," 106 J. of Accountancy 48 (Dec. 1958); Pennell, "Tax Planning at the Time of Incorporation," 35 Taxes 927 (1957); Diamond and Segal, "The Thin Corporation Problem: Its Present Status and Recommendations for Improvement," 25 Geo.Wash.L.Rev. 588 (1957); Rabin, "The 'Clifford Case' of the Thin Corporation," 34 Taxes 282 (1956); Spanbock, Carro, and Katz, "Nourishing the Thin Corporation," 34 Taxes 687 (1956); Bittker, "Thin Capitalization: Some Current Questions," 34 Taxes 830 (1956), 10 U. of Fla.L.Rev. 25 (1957); "Thin Capitalization and Tax Avoidance," 55 Col.L.Rev. 1054 (1955); "Financing of Small Corporations, Debt or Equity," 42 Marquette L.Rev. 387 (1959).

See also Stanford, "What Is Adequate Capitalization?" 31 Taxes 231 (1953); Kramer, "The Thin Corporation Problem," 96 J. of Accountancy 449 (1953); Semmel, "Loan Versus Investment—Inadequate Capitalization," 5 Tax L.Rev. 424 (1950); Semmel, "Tax Consequences of Inadequate Capitalization," 48 Col.L.Rev. 202 (1948); Schlesinger, "Thin Incorporations: Income Tax Advantages and Pitfalls," 61 Harv.L.Rev. 50 (1947).

For example, if a man pays the interest which his brother owes to a bank on the brother's loan, without any liability to do so, the payor cannot deduct anything for interest paid. Similarly, if a mans buys property for $1,000, payment to be made a year hence, he cannot deduct anything for interest paid, unless interest is separately specified in the contract.

Note, however, two provisions of the 1954 Code which qualify this rule. By sec. 163(b) a deduction may be had for interest where personal property is bought in installments, and carrying charges are separately stated, even though the actual amount of interest cannot be determined. See also sec. 1.163–2 of the Income Tax Regulations. And by sec. 216, a tenant in a cooperative apartment house can deduct his pro rata proportion of interest. This latter provision is also applicable to real estate taxes on the land and building.

REVENUE RULING 54–94

Internal Revenue Service, 1954. 1954–1 Cum.Bull. 53.

The attention of the Internal Revenue Service has been called to several situations where taxpayers are attempting to derive supposed tax benefits in connection with transactions designed to obtain interest deductions, for Federal income tax purposes. The question is whether the amounts designated as "interest" are deductible under section 23(b) of the Internal Revenue Code. The following two examples are illustrative:

Example 1: M Insurance Company has sold to the taxpayer an "annunity savings bond" (herein called the "bond") under the following conditions: Taxpayer "pays" to M a single cash premium of $100,000. To finance the premium, taxpayer pays $100 to M in cash and "borrows" $99,900 from M on a note that bears "interest" at the rate of 5 percent the first year and 3 percent thereafter. Taxpayer is not personally liable on the note, M's sole recourse being against the bond.

The bond has a maturity of 30 years. The "cash value" of the bond is $100,000 at the time the bond is issued and the "cash value" increases at the rate of 2½ percent a year compounded annually. At maturity taxpayer will be entitled to an annuity based on the "net cash value" of the bond at that time, i. e., the excess of the "cash value" over the unpaid balance on taxpayer's note to M. Taxpayer has the election at maturity to receive in cash the "net cash value" of the bond, and if taxpayer dies before maturity a beneficiary named by him is entitled to the then "net cash value".

(In some cases of this type it is provided that the taxpayer may surrender the bond at any time after 1 year and receive the "net

cash value" thereof at such time. In some cases it is provided that the taxpayer may at any time borrow the "net cash value" on the bond on a nonrecourse note without surrendering the bond. In such cases there may be no "net cash value" at maturity and if so no annuity will be paid. In some cases it is provided that the taxpayer may at any time suspend payment of "interest" except to the extent of one-sixteenth of 1 percent without surrendering the bond, and the "cash value" of the bond will cease to increase during such suspension.)

Taxpayer claims that for Federal income tax purposes he may deduct the "interest" that he "pays" on the amount that he has "borrowed" on the bond, but that he realizes capital gain if he sells the bond. If this is so, and if taxpayer's surtax rate is sufficiently high, he will make a "profit" on the transaction notwithstanding that he pays 3 percent "interest" for a 2½ percent investment.

Example 2. In July 1952 taxpayer, an individual who is not a dealer in securities, purported to "purchase" $5,000,000 United States Treasury 1⅜ percent notes due March 15, 1954, at $99. Taxpayer financed the "purchase" by making a small down payment and purported to "borrow" the balance from the N Company, a dealer in securities, on a 2¼ percent nonrecourse note maturing March 15, 1954, depositing the Treasury notes as sole security for the principal and interest on the note. N thereupon sold short the same amount of Treasury notes of the same series, and with taxpayer's consent N covered the short sale with the deposited Treasury notes, thereby receiving the funds which it had "loaned" to the taxpayer. Taxpayer may direct the sale of his Treasury notes at any time. It is contemplated that at or before maturity taxpayer will direct the sale of his Treasury notes, and N will purchase $5,000,000 of such notes at the then market price to cover its short sale.

(In some cases of this type the taxpayer "pays" part of the "interest" on the note to N with money "borrowed" from N on an additional nonrecourse note.)

Since the taxpayer will "pay" more "interest" on the note to N than the total of the interest and appreciation that he will realize on the Treasury notes, taxpayer will realize no profit on the transaction apart from the effect of the transaction on his Federal income tax. However, taxpayer, whose surtax rate is sufficiently high, seeks to make a "profit" by deducting the "interest" that he pays from ordinary income and reporting the gain on the sale of the Treasury notes as capital gain.

It is the view of the Internal Revenue Service that amounts paid by taxpayer and designated as "interest" in the above examples are not interest within the meaning of section 23(b) of

the Code, and are not deductible for Federal income tax purposes. Cf. *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552, Ct.D. 456, C.B. XI-1, 274 (1932), where the Supreme Court indicated that interest is "the amount which one has contracted to pay for the use of borrowed money."

In the above examples the amounts paid by the taxpayer are not in substance payments for the use of borrowed money. As a matter of substance the taxpayer does not borrow any money, hence there is no "debt" on which he pays "interest." An instrument that is called a "note" will not be treated as an indebtedness where it does not in fact represent an indebtedness. See *Talbot Mills v. Commissioner*, 326 U.S. 521, Ct.D. 1660, C.B. 1946-1; 191; *Matthiessen, et al. v. Commissioner*, 194 F.2d 659. In example 1, part of the "interest" paid by the taxpayer will be returned to him through the increase in the value of the bond and the remainder represents a payment to M for arranging the transaction so that taxpayer may derive a supposed tax benefit. If it is possible to regard the transaction as an annuity transaction at all, the "interest" payments in reality represent the premiums aid for the annuity. If the transaction is regarded as an endowment contract, the "interest" deduction is to be disallowed under section 24(a)(6) of the Code. In example 2, taxpayer in substance pays a sum of money to the N Company for arranging a transaction lacking commercial substance so that taxpayer may derive a supposed tax benefit; taxpayer does not expect to make a cash profit on the transaction independent of Federal income tax consequences, nor does taxpayer risk the money that he "borrows." Cf. *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572, where the Court of Appeals for the Second Circuit emphasized that "in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."

Notes

(A) The position taken by the Treasury in this ruling has been generally sustained by the courts. Thus, interest deductions have been denied in connection with elaborate schemes for the purchase of large amounts of securities on credit, with the securities put up as collateral for the loan, where the objective was to obtain a capital gain, taxable at low rates, which would leave a profit even after the payment of a larger amount of interest *if* the interest is fully deductible against ordinary income at high rates. See *Lynch v. Commissioner*, 273 F.2d 867 (C.A.2d, 1959); *Goodstein v. Commissioner*, 267 F.2d 127 (C.A.1st, 1959); *Becker v. Commissioner*, 277 F.2d 146 (C.A.2d, 1960). A similar result was reached in *Danny Kaye*, 33 T.C. 511 (1959), involving the purchase of a certificate of deposit at a discount,

with borrowed money, and in *Weller v. Commissioner,* 270 F.2d 294 (C.A.3d, 1959), and *Knetsch v. United States,* 272 F.2d 200 (C.A.9th, 1959), in both of which a borrowing scheme involving annuity policies was held to be without substance. But see, *contra, United States v. Bond,* 258 F.2d 577 (C.A.5th, 1958), Wisdom, J., dissenting.

In *L. Lee Stanton,* 34 T.C. 1 (1960), there was real borrowing from an independent bank, with full liability on notes, and real purchase of securities. A majority of the Tax Court allowed the deduction of the interest.

(B) *Special provisions disallowing the deduction of interest.* Note the provisions of **sec. 264** of the 1954 Code which disallow the deduction of certain interest payments in connection with life insurance and annuity policies.

Interest on indebtedness which is paid or incurred to purchase or to carry tax exempt securities is not deductible. Sec. 265(2) of the 1954 Code. This provision in an earlier statute was held to be constitutional in *First Nat. Bank v. United States,* 283 U.S. 142 (1931).

Reference has already been made to sec. 266 under which carrying charges (ordinarily including interest) are not deductible where the taxpayer has elected to capitalize them.

Taxes

Sec. 164 of the 1954 Code, and secs. 1.164–1 through 1.164–7 of the Income Tax Regulations

The deduction for taxes [1] is rather fully spelled out in sec. 164. Many taxes, particularly federal taxes, are not deductible under sec. 164(b). But regular real estate taxes are deductible, even on a personal residence. The qualification of sec. 262 that "personal, living, or family expenses" are not deductible is not given any applicability in respect of the deductions for taxes and interest. Query: Does this represent an undue discrimination against renters and in favor of home owners?

"Apportionment" of real estate taxes. In many localities, it is the practice on the purchase of real estate that taxes are "apportioned." Suppose that property is purchased for a contract price of $15,000 on July 1st. The annual taxes are $500, and the parties agree that they shall be apportioned. Under this arrangement, the buyer would actually pay the seller $14,750 ($15,000 less the seller's half of the taxes for the first half of the year), and the buyer would, at the proper time, pay the $500 tax bill, making his total outlay come to $15,250 ($14,750 paid to seller,

[1] See Gray, "Deductions from Gross Income: Payments and Accruals Deductible as "Taxes,'" 3 Wash. & Lee L.Rev. 1 (1941).

plus $250 taxes paid for the seller, plus $250 taxes for the buyer's half of the year). In *Magruder v. Supplee*, 316 U.S. 394 (1942), the Supreme Court held that the buyer could not deduct anything on account of taxes in this situation, at least where the taxes were a lien at the time of purchase. The amount paid by the buyer was held to be simply the purchase price for the property—he paid $14,750 for the property subject to a lien, plus $500 to remove the lien on it. (Apparently the seller could not deduct anything for taxes, either, since he did not pay the taxes.)

This rule has been changed by **sec. 164(d)**, a provision which is new in the 1954 Code. See also sec. 1.164–6 of the Income Tax Regulations; Cannon, "The Apportionment of Real Estate Taxes under Section 164(d) of the 1954 Code," 12 Tax L.Rev. 433 (1957). This will help to bring the tax law more nearly into conformity with the standard practice in the real estate field.

Note that so called "special assessments"—taxes imposed to pay for a benefit or improvement—are ordinarily not deductible. Sec. 164(b)(5). They are regarded as a capital cost resulting from the acquisition of new or improved property.

As in the case of interest, the rule is that taxes are deductible only by the one who pays them. If a man pays someone else's taxes, he gets no deduction for taxes paid. See sec. 39.23(c)–1 of Regulations 118. (He may even be subject to a gift tax!) In the case of state and local retail sales and gasoline taxes, however, it is provided in sec. 164(c) that these, if separately stated, shall be deductible by the purchaser, even though they are formally imposed on the seller. See also sec. 1.164–5 of the Income Tax Regulations. Note that this is applicable only to state and local taxes. State gasoline taxes are deductible. The federal gasoline tax is not deductible by the purchaser as a tax, since it is imposed on the refiner. The federal gasoline tax may be deductible by the purchaser as a business expense under sec. 162 (or under sec. 212) if the gasoline is used for business purposes or for the production of income.

Taxes are deductible when paid by the person who owes them. It is also clear that they may be deducted when paid by a person who has a beneficial interest in property, when paid to protect that interest, even though the title may be in another, and the tax is not assessed to the payor. See *Estate of Mary Rumsey Movius*, 22 T.C. 391 (1954).

Credit for foreign taxes

If a taxpayer pays taxes to a foreign country, he may if he chooses take the taxes as a *credit* against his liability for taxes to the United States, subject to limitations stated in the statute. **Secs. 901–905** of the 1954 Code. See also secs. 1.901–1 through 1.905–4 of the Income Tax Regulations. If he elects to take the credit, the foreign taxes are not allowed as a deduction. See sec. 164(b)(6). If the taxpayer is a corporation, it may be able to take credit for some or all of foreign taxes paid by a company in which it owns at least 10% of the stock. Sec. 902 of the 1954 Code.

This credit is designed to prevent double taxation in the case of foreign earned income. The general effect of the limitations is that the foreign income will pay tax at the higher of the foreign or domestic rates, but will not bear the burden of both taxes. The question whether the taxpayer has actually paid the tax as tax is also presented here. See *Biddle v. Commissioner,* 302 U.S. 573 (1938), where it was held that taxes withheld by British corporations, under the British income tax law, from dividend payments made to shareholders, were in fact paid by the corporation, and not by the shareholder, and thus were not available for the credit. The question of the exact amount of the credit allowable under the limitation prescribed by sec. 904 may be a matter of considerable difficulty. See *American Chicle Co. v. United States,* 316 U.S. 450 (1942).

For discussion of the foreign tax credit and related matters, see "Taxation of Income from Foreign Sources," 68 Harv.L.Rev. 1036 (1955); Baker, "Foreign Holding Companies and Foreign Tax Credits," 34 Taxes 746 (1956); Brainerd and White, "Foreign Tax Credit: The Homology and the Anomaly," 36 Taxes 821 (1958); Swanson, "Royalties and Technical Assistance Arrangements," 36 Taxes 825 (1958).

Treaties. In addition to the foreign tax credit, a large number of treaties have been entered into for the purpose of limiting or preventing international double taxation. These are referred to at pp. 16–17, above.

Suppose a foreign country wants to provide a tax incentive to induce businesses to come to it. It provides that a company which opens a new plant will pay no taxes, or low taxes, for five or ten years after it comes in to the foreign country. If it is a United States company, though, no taxes are saved, since the only effect is to reduce the foreign tax credit, and the company simply pays to the United States the taxes it is forgiven by the foreign

country. Thus the incentive is lost. Should the United States allow a credit for taxes *not* paid to the foreign country in this situation? Should the Senate ratify a treaty with such a provision? See Kust, "United States Tax Concessions for American Private Enterprise Abroad," 12 Tax Executive 143 (1960); Surrey, "The Pakistan Tax Treaty and 'Tax Sparing'," 11 Nat. Tax J. 156 (1958); Crokett, " 'Tax Sparing': A Legend Finally Reaches Print," 11 Nat.Tax J. 146 (1958).

Losses

Sec. 165 of the 1954 Code, and secs. 1.165–1 through 1.165–10 of the Income Tax Regulations

REPORTER PUBLISHING CO., INC. v. COMMISSIONER

Court of Appeals, Tenth Circuit, 1953. 201 F.2d 743.
Certiorari denied 345 U.S. 993 (1953).

HUXMAN, CIRCUIT JUDGE. The question presented for our consideration is whether the appellant taxpayer sustained a deductible capital loss for income tax purposes by reason of the decision of the Supreme Court of the United States in *Associated Press v. United States*, 326 U.S. 1, holding illegal the by-laws of the Associated Press granting to appellant as a member thereof an excusive membership in the Association and the exclusive right to Associated Press services in its community. The Tax Court in a decision reviewed by the full court unanimously held that no deductible loss was sustained and the taxpayer has appealed.

On March 1, 1940, taxpayer purchased the assets of the Independence Daily Reporter, a daily newspaper published at Independence, Kansas, for a total consideration of $150,000. A bond issue was necessary to finance the purchase of the paper. Included in the assets was a membership in the Associated Press which was valued by the engineer for the brokerage firm handling the bond issue at $70,735. The Associated Press membership under the by-laws existing at that time entitled the taxpayer to the exclusive news gathering facilities of the Associated Press. Without appellant's consent, no competing paper in its territory could obtain such a membership and the benefits flowing therefrom. The taxpayer assigned a value of $79,734.67 to the Associated Press membership on its books.

In its decision the Supreme Court held that the by-laws of the Associated Press relating to the conditions under which new members might be admitted in territory where a newspaper held such a membership were illegal because they unlawfully restrained trade in violation of the Sherman Anti-Trust Act.[1] The effect

[1] 26 Stat. 209, 15 U.S.C.A. § 1 et seq.

of the decision was to prohibit any restriction upon a new membership based solely upon the status of the new member with respect to competition with an existing membership.

Following the decision by the Supreme Court, the taxpayer reduced the value of its membership on its books from $79,734.67 to $50,000 and took in its income tax return for the fiscal year in question a deduction of the difference of $29,734.67 from its gross income as a loss sustained in that year, resulting from such decision. The commissioner disallowed the deduction and imposed resulting deficiencies in tax. Before the Tax Court the taxpayer took the position that the decision of the Supreme Court completely destroyed the value of the capital asset consisting of the Associated Press membership; that its total value as reflected on its books should have been deducted and that the tax accountant who prepared the return failed to take the full deduction because he did not realize the legal effect of the decision. That was its position before the Tax Court and was the theory on which the case was tried and decided and that is the position it takes on this appeal.

There is no dispute in the applicable principles of income tax law relating to capital gains and capital losses or to the factors that must exist before one is chargeable with a capital gain or may take the benefit of a capital loss as a deduction from gross income. A taxpayer is not chargeable with a capital gain resulting from an enhanced value of a capital asset while it is still being used in the business; neither may he take a deduction from gross income because of the diminution in value of such an asset while it is still a part of the business and is being used in the business. Since there is no conflict in the decisions with respect to these principles of law, citing numerous decisions in support thereof would be superfluous and add nothing of value to the opinion.

Section 29.23(e)–1 promulgated under the Internal Revenue Code and made applicable to corporations by Section 29.23(f)–1 provides that "losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses." And Section 29.23(e)–3 so far as material provides that when "the usefulness in the business of some or all of the assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as loss for the year in which he takes such action the difference between the basis . . . and the salvage value of the property."

These regulations implementing the statute make it clear that before one may take a capital loss deduction the capital asset must be liquidated, generally by sale, or in event by some definitely identifiable event or, if its usefulness in the business has been destroyed and it is not sold, it must be permanently discarded from use in the business.

Since deductions from gross income are matters of legislative grace, one who seeks the benefit thereof must bring himself clearly within the statute or an effective regulation authorizing the deduction.[2] In line with these principles it has been held consistently that a deduction under the statute and regulation in question may be claimed only when there is a closed transaction during the taxable year, generally evidenced by a sale of the asset or abandonment of the asset as completely worthless.[3]

For the purpose of the opinion, it may be conceded that the decision by the Supreme Court effected a diminution in value of the Associated Press membership. It is no doubt much less desirable since the holder thereof may no longer prevent a competitor from having such a membership. But this is a far cry from saying that it is valueless. The present membership still enables the taxpayer to receive all the services therefrom that he received before the decision by the Supreme Court. If it did not hold this membership, it would be seriously handicapped in the conduct of its business. If it did not hold such membership and applied for one, it would be required to pay an initial charge in addition to the regular charges for the services furnished and, if the taxpayer sold his business and transferred the membership with it, the purchaser likewise would be entitled to full benefits of the membership without the payment of initial fees, which otherwise would be required. There are other elements of value in the ownership of this membership which need not, however, be spelled out because in any event appellant has not brought itself within the statutory provisions entitling it to the claimed deduction. The best evidence of value is found in the fact that appellant continues to use the membership in the same way and with the same benefits as before the decision by the Supreme Court. If the membership had no value or utility, it would be a simple matter to surrender it and eliminate it entirely from the business. Then appellant would be entitled to the claimed deduction. But so long as the membership is being retained and used in the business, in the

2 Interstate Transit Lines v. Commissioner, 319 U.S. 590; Commissioner of Internal Revenue v. Thompson, 10 Cir., 193 F.2d 586; Chicago Mines Co. v. Commissioner, 10 Cir., 164 F.2d 785; Hales-Mullaly v. Commissioner, 10 Cir., 131 F.2d 509.

3 Pugh v. Commissioner, 5 Cir., 49 F.2d 76; Commissioner of Internal Revenue v. McCarthy, 7 Cir., 129 F.2d 84; In re Rae's Estate, 3 Cir., 147 F.2d 204; Louisiana Land and Exploration Co. v. Commissioner, 5 Cir., 161 F.2d 842.

same way, for the same purposes and with the same beneficial results, it cannot be said to have no value.

We think the conclusions reached by us find support in the case of *Consolidated Freight Lines v. Commissioner*, 9 Cir., 101 F.2d 813. There the monopolistic rights of a certificate of public convenience and necessity for which a valuable consideration had been paid were conferred by statute. A statute subsequent to the purchase of the certificate abolished and wiped out the monopolistic features of the certificate. It was contended, as here, that this destroyed the value of the certificate and entitled the taxpayer to a capital loss deduction. While the facts are not identical with the facts in this case, we think the court's conclusion that the destruction of the monopoly resulted only in a diminution of value of the certificate is equally applicable here.

Affirmed.

Notes

(A) In *United States v. S. S. White Dental Co.*, 274 U.S. 398 (1927), the Court held that a loss sustained when the German Government in 1918 seized the taxpayer's German branch might be deducted in 1918 despite the possibility that some sort of claim might thereafter be presented against the German Government. The Court said (pp. 402–403): "The quoted Regulations, consistently with the statute, contemplate that a loss may become complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment. . . . The Taxing Act does not require the taxpayer to be an incorrigible optimist." In *Lewellyn v. Electric Reduction Co.*, 275 U.S. 243 (1927), the taxpayer in 1918 paid in advance for certain goods to be delivered. Only a small delivery was made, and in March, 1919, the taxpayer brought suit to recover its payment. The Court held that the transaction was a loss, rather than a bad debt, and that the loss was not deductible in 1918. "There is nothing in the findings from which we could conclude that the respondent in 1918 had ceased to regard his rights under the contract as having value or that there was then reasonable ground to suppose that efforts to enforce them would be fruitless." 275 U.S. at 247.

(B) *War losses.* During World War II questions of the deductibility of war losses were covered in special provisions of the statute. Sec. 127 of the Code of 1939, added in 1942. Questions still arise with respect to the recovery of property that was lost during the war. Elaborate rules on this question are spelled out in secs. 1331–1337 of the 1954 Code. For a discussion of the problems, see Kramer, "War Losses, Their Continuing Effect under Section 127," 30 Taxes 376 (1952).

(C) How far may intangible property be the subject of a casualty loss? Most of the cases have held that a casualty loss deduction cannot be taken on account of loss of good will. For an argument to the contrary, see Bachrach, "Good Will as a Casualty Loss Deduction," 35 Taxes 347 (1957).

(D) *Tearing down a building.* When a taxpayer buys land with a building on it, and intends at the time of purchase to tear down the building, in order to replace it, or, perhaps, to use the property for a parking lot, no loss is deductible on account of the building. The entire amount paid, plus the cost of removing the building, are treated as the cost of the land. See sec. 1.165–1(b) of the Income Tax Regulations; *Lynchburg Nat. Bank & Trust Co.,* 20 T.C. 670 (1953), aff'd 208 F.2d 257 (C.A.4th, 1954).

However, if there was no purpose to take down the building when it was acquired, the loss on a subsequent demolition is deductible. *Dayton Co. v. Commissioner,* 90 F.2d 767 (C.C.A.8th, 1937); *Jack M. Chesbro,* 21 T.C. 123 (1953). If, however, the old building is taken down for the purpose of replacing it with a new building, the remaining basis for the old building plus the cost of removing it become part of the cost of the new building. *Union Bed & Spring Co. v. Commissioner,* 39 F.2d 383 (C.C.A. 7th, 1930); *Estate of Appleby v. Commissioner,* 123 F.2d 700 (C.C.A.2d, 1941).

(E) *Losses of individuals.* Note that all losses of corporations are deductible (unless compensated for by insurance), while the deductions of individuals for losses are limited to three groups. Sec. 165(c) of the 1954 Code. These are by no means limited to "business" losses, as sec. 165(c)(3) allows the deduction of many personal losses, such as the destruction of one's residence by fire, or the theft of an oil painting from a home.

Perhaps the most significant word in sec. 165(c) is "casualty." What is a loss "by other casualty"? Damage to a residence from the freezing and breaking of pipes is deductible. O.D. 1076, 5 Cum.Bull. 138 (1921). In *Keenan v. Bowers,* 91 F.Supp. 771 (E.D.S.C.1950), the taxpayer's wife took off her rings at night, and wrapped them in a piece of kleenex. The husband, having a nose irritation, used some kleenexes during the night. In the morning, he picked up all the kleenexes, and put them down the toilet. The ring was included, although he did not know it. The ring was not recovered. It was held that that was not a loss by "other casualty," and no deduction was allowed.

Damages paid for injuries to the person or property of another are not deductible under this provision. O.D. 779, 4 Cum.Bull. 155 (1921); *Luther Ely Smith,* 3 T.C. 696 (1944).[1]

(F) Since a loss of a residence by fire is deductible, who gets the benefit of fire insurance on a residence, particularly if the owner is in high brackets? Does this have any bearing on the desirability of maintaining fire or storm insurance on a personal residence? Should fire and storm insurance premiums be deductible in order to make the burden of the cost of the insurance fall on the party who benefits by it? Cf. Holzman, "The Tax Consequences of a Loss," 36 Taxes 49 (1958).

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[1] For a discussion of the problems, see Caplin, "Casualty Losses: Recent Developments," N.Y.U.12th Ann.Inst. on Fed. Taxation 525 (1953); Felt, "Tax Effects of Hurricane Losses," 33 Taxes 327 (1955).

ROSENBERG v. COMMISSIONER

United States Court of Appeals, Eighth Circuit, 1952. 198 F.2d 46.

COLLET, CIRCUIT JUDGE. The sole question for determination on this petition for review of the decision of the Tax Court of the United States is whether a loss to a dwelling house caused by termites is deductible from income as a "casualty" within the meaning of Section 23(e) (3) of the Internal Revenue Code. The pertinent portions of that section are:

> "§ 23. Deductions from gross income.
>
> "In computing net income there shall be allowed as deductions:
>
> * * * * * * * * *
>
> "(e) *Losses by individuals.* In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—
>
> "(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. * * *"

The facts are not disputed. The findings of fact of the Tax Court are:

> "Petitioner's individual income tax return for the taxable year 1947 was filed with the collector for the first district of Missouri at St. Louis, Missouri. He resides with his wife at No. 4 Prado Drive, Ladue 5, St. Louis County, Missouri. He purchased the property in April, 1946, for $38,500. Prior to purchase he had the property inspected to determine whether there were termites by one Schlesinger, a builder and architect of over 15 years' experience. The architect checked the joists with a sharp-pointed instrument and by pounding with a hammer and informed petitioner that he was satisfied that the construction was sound. Petitioner thereupon purchased the property, moved into it in September, 1946, and has resided therein since that time.
>
> "In April, 1947, termites were discovered and after Schlesinger had been called and agreed there were termites an examination was made by an entomologist, a specialist on termites, and it was found by him that damage done by termites was confined to a small area. A joist in the basement, measuring 2 inches by 8 inches, had been affected to a length of about 10 or 12 feet. The rest of the joist was solid and it was only necessary to nail to it a small piece of wood where the joist had possibly been weakened. Also, the sills and jambs of a picture window were affected by the termites to the extent of about 8 or 10 inches. That part of the wood was sawed off and a new piece of wood put in to replace it. Because of damage to the sill of a plate glass window it was

> necessary to take the plate glass out and replace the subsill and the finish sill and put in a new jamb and then replace the plate glass. The termite expert treated the entire building for termites. The total amount expended for treatment and the repairs made was $1800.74 and that amount was claimed by the petitioner as a deduction in his income tax return for 1947 as 'Damage to No. 4 Prado Drive caused by Termites.' The claim was denied.
>
> "Termites are social insects and the infestation by the termites in petitioner's home was a colony project rather than the work of a few individual insects. The known presence of termites in a house makes it difficult to sell it."

We need only add that the area affected (other than the floor joist), described as a "small area", consisted of an area of five or six feet adjacent to the point of entry of the termites through a small crack in the foundation and that the colony of termites was of recent origin at the date of the inspection in April, 1947. Since the Tax Court found that whatever loss or damage was occasioned by the termites was not deductible, it did not determine the amount of the loss.

The question presented is not new. The Ninth Circuit held in *United States v. Rogers*, 120 F.2d 244, 246, that the word "casualty" connoted the sense of suddenness, and that as used in Sec. 23, Webster's definition applied:

> " '1. Chance; accident; contingency; also, that which comes without design or without being foreseen; an accident * * *
>
> " '2. An unfortunate occurrence; a mischance; a mishap; a serious or fatal accident; a disaster * * *.' "

That court said:

> "It can be seen that 'casualty' may properly be used in the sense of 'accident'. The latter word is defined by the same source as 'An event that takes place without one's foresight or expectation; an undesigned, sudden, and unexpected event'. Showing that casualty may have the sense of suddenness is the definition in 1 Bouv.Law Dict., Rawle's 3d Rev., p. 430, as follows: 'Inevitable accident. Unforeseen circumstances not to be guarded against by human agency, and in which man takes no part'. Such definition is in accord with that given in *Matheson v. Commissioner of Internal Revenue*, 2 Cir., 54 F.2d 537, 539.
>
> "Since damage by termites or dry rot is not a sudden occurrence but is a development over a longer period of time we think the deduction was improper."

On rehearing, *United States v. Rogers*, 9 Cir., 122 F.2d 485, that court applied the doctrine of ejusdem generis and held that the statute should be construed as though it read " 'loss by fires,

storms, shipwrecks, or other casualty of the same kind' ", and held that the class was distinguished by the *suddenness* of the loss, saying:

> "The similar quality of loss by fire, storm or shipwreck is in the suddenness of the loss, so that the doctrine requires us to interpret the statute as though it read 'fires, storms, shipwrecks or other sudden casualty'."

The Second Circuit in *Fay v. Helvering*, 120 F.2d 253, again held that loss from termite destruction was not a "casualty", . . .

While both the *Rogers* and *Fay* cases involved loss caused by termites, the facts involved are, in the respect that the deterioration was very slow in developing, different in those cases from the facts in this case. In the *Rogers* case the house was purchased in 1920 and improved in the following year. Not until 1929 was extensive damage "from some cause of the nature of termites or dry rot" discovered. And then the damage was so extensive that upon the advice of an architect the entire building was razed. In the *Fay* case the house was built in 1913 and in 1935 it was discovered that termites had eaten away the entire strength of the wooden framework of the columns and horizontal beams that supported the roofs of a porch at either end of the house. The court observed that—"The insects had obviously been at work for a long time, and the loss had therefore in fact taken place gradually although it was not discovered until it was complete." . . .

We deem it appropriate to note that from our examination of the authorities that through the cases, and particularly the *Rogers* and *Fay* cases, runs the dominant thought that the primary characteristic of casualties which will fall within the meaning of Sec. 23 is that of the suddenness of the occurrence. As said in *Matheson v. Commissioner*, [54 F.2d 537]—"the word 'casualty' * * * is an event due to some sudden, unexpected, or unusual cause. *Anything less than this renders it hardly distinguishable from depreciation from ordinary wear and tear* which cannot be deducted by a taxpayer in the case of property that is not used in trade or business." (Italics ours.) . . .

We agree with the definition of "other casualty" found in the *Rogers* and *Fay* cases that the occurrence must be sudden. We agree that the doctrine of ejusdem generis should be applied and that the characteristic of suddenness common to fires, storms, and shipwrecks must exist in order that the occurrence causing the loss be a casualty within the meaning of Sec. 23. But it is inherent in the application of the rule of ejusdem generis that the class of occurrences which will constitute "other casualties" will not be confined to fires, storms, or shipwrecks alone. To do so would violate the intent of the rule and also the intent of Congress

in inserting the words "or other casualty" in the Act of 1916. We do not assume that the courts which have held that losses caused by termites were not deductible were intending to hold that loss or damage from an invasion of termites was under no circumstance deductible. It is clear from those opinions that the lack of demonstrated suddenness of the loss was the controlling factor in those decisions. If the loss from termites had been shown to have been sudden in those cases and the criterion of a sudden invasion of a hostile agency had been applied, it seems reasonably clear that the result would have been different. We understand the doctrine enunciated by those cases to be that if the operating forces which give rise to a loss are shown to be a sudden invasion of a hostile agency, the loss will be deductible as a casualty. Naturally, we are not now concerned with the question existing in the *Fay* and *Rogers* cases of whether the evidence in a particular case showed that an operating force, capable of sudden destruction, actually did or did not act with suddenness, for as we shall demonstrate, the proof in this case does show that the operating force did act with suddenness and was a hostile agency.

Suddenness is a comparative term. That is demonstrated not only by the ordinarily accepted meaning of the word, but also by the fact that the courts have held that the element of suddenness existed in a great variety of occurrences where the degree of suddenness varied widely. And being comparative, it is necessary that in each case the class of occurrences which is to be excluded as not being sudden be ascertained in order to identify the opposite element for making the comparison. In that manner the segregation of those things which should fall into the intended meaning of things sudden from those which were intended to be excluded can best be accomplished. . . .

It is commonly known that residence buildings in this climate, properly constructed and maintained, have an ordinary life of from 25 to 50 years, or even longer, the variation between those periods resulting from the type of materials used. Comparatively speaking, an invasion of a colony of termites which destroys the timbers of a building in a month, three months, or a year, is a sudden destruction, when from natural depreciation it would have required from 25 to 50 years or longer for them to have been substantially injured. The damage done by termites in a relatively short time may not have the same dramatic characteristics as destruction reasonably to be anticipated from the invasion of a bull into a china closet, but the damage from termites would be as effective and possibly more so, and when the time necessary to accomplish substantial loss in both instances is compared with the time necessary to result in damage from natural depreciation, both would be relatively very sudden.

The facts in this case may be and probably are unusual in that the time within which the damage or loss occurred could be and was definitely fixed within a relatively short time. . . . We are forced to the conclusion that the Tax Court erred in holding that the loss was not deductible. Since that court did not determine the amount of deductible loss, the cause is remanded for further proceedings not inconsistent with this opinion.

The dissenting opinion of JOHNSEN, CIRCUIT JUDGE, is omitted.

Notes

(A) *Loss on sale of personal residence.* A loss on the sale of a personal residence is not deductible where the residence was used as such up to the time of the sale. Such a loss is regarded as a personal, living, or family expense which is not deductible under sec. 262. This is true also where the property was first acquired for rental purposes and so used, but was then used as a personal residence up to the time of the sale. I.T. 3544, 1942–1 Cum.Bull. 156. It is also true even though the taxpayer had ceased for some time to occupy the premises as a residence, had made efforts to rent it prior to sale, and had expended substantial sums to place it in a more salable condition.[1] *Jones v. Commissioner,* 152 F.2d 392 (C.C.A.9th, 1945).

Suppose the property was lived in, then rented for a period, and then sold. Is a loss deductible?

Where property is inherited, and sold at a loss without ever being used as a residence by the taxpayer, the loss has been held to be deductible. I.T. 3776, 1946–1 Cum.Bull. 65.

Where the property is used partly for business and partly for a residence a loss is deductible in proportion to the extent of the business or income producing use of the property. Rev.Rul. 286, 1953–2 Cum.Bull. 20.

Time for Deduction

A number of questions arise as to the time when a deduction for a loss should be taken.

In *Boehm v. Commissioner,* 326 U.S. 287 (1945), it was held that a loss on a security was sustained when the security actually became worthless and not when the taxpayer in good faith believed that it had become worthless. In other words, an "objective" rather than a "subjective" test was applied to this question.

In *United States v. Barret,* 202 F.2d 804 (C.A.5th, 1953), it appeared that an orchard had been subjected to a considerable freeze. For the next two years the owner carried out various steps which were designed to save or bring back the trees. After that period, the effort was found to be hopeless and the orchard

1 For a criticism of this rule, see Roehner and Roehner, "Loss Deduction on the Sale of an Abandoned Residence: Case-Law Thinking in Statutory Interpretation," 23 Fordham L.Rev. 196 (1954). See also Swanson, "Loss on the Sale of Residential Property," 33 Taxes 589 (1955).

was abandoned. It was held that the loss was deductible in the year in which the efforts to restore the property proved unsuccessful.

Suppose there is insurance. A loss is sustained. A controversy develops about the insurance. This controversy is finally settled two years later, with a payment by the insurance company of a portion of the loss. The remainder of the loss is deductible at that time. *Commissioner v. Harwick,* 184 F.2d 835 (C.A.5th, 1950). The mere fact that insurance, covering a part of the loss, is not paid until the following year, is no reason for not deducting the balance of the loss in the year of the fire. *Harry Brown,* 23 T.C. 156 (1954).

Losses from theft, including embezzlement. For some time there was considerable difficulty about the time when embezzlement and other theft losses should be deducted. The statute provides that losses "sustained" are deductible, and it is at least arguable that a loss from embezzlement is sustained when the money is taken, even though the loss is not discovered until years later. By that time the statute of limitations may have run on the earlier year. This question was dealt with in *Alison v. United States,* 344 U.S. 167 (1952). The point is now covered by sec. 165(e), a new provision in the 1954 Code. It specifies that a loss from theft is deductible in the year in which it is discovered.

Note

In 1935, a successor trustee commenced actions against his predecessors for diversion of trust assets. In 1940, he obtained large judgments against them, and a further judgment against a bank was obtained in 1948. Except for relatively small payments, these judgments proved to be uncollectible. The successor trustee deducted the amount of the loss on the trust's tax return for 1948. This was allowed. The court held that it was reasonable for him to expect recovery when he filed suit in 1935, and the fact of the loss did not become clear until 1948. *Scofield v. Commissioner,* 266 F.2d 154 (C.A.6th, 1959). The Treasury has announced that it will accept and follow this decision. Rev.Rul. 59–388, 1959–2 Cum.Bull. 76.

HELVERING v. OWENS

Supreme Court of the United States, 1939. 305 U.S. 468.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The courts below have given opposing answers to the question whether the basis for determining the amount of a loss sustained during the taxable year through injury to property not used in a trade or business, and therefore not the subject of an annual depreciation allowance, should be original cost or value immediately before the casualty. To resolve this conflict we granted certiorari in both cases.

In No. 180 the facts are that the respondent Donald H. Owens purchased an automobile at a date subsequent to March 1, 1913, and prior to 1934, for $1,825, and used it for pleasure until June 1934 when it was damaged in a collision. The car was not insured. Prior to the accident its fair market value was $225; after that event the fair market value was $190. The respondents filed a joint income tax return for the calendar year 1934 in which they claimed a deduction of $1635, the difference between cost and fair market value after the casualty. The Commissioner reduced the deduction to $35, the difference in market value before and after the collision. The Board of Tax Appeals sustained the taxpayers' claim and the Circuit Court of Appeals affirmed its ruling.

In No. 318 it appears that the taxpayers acquired a boat, boathouse, and pier in 1926 at a cost of $5,325. In August 1933 the property, which had been used solely for pleasure, and was uninsured, was totally destroyed by a storm. Its actual value immediately prior to destruction was $3,905. The taxpayers claimed the right to deduct cost in the computation of taxable income. The Commissioner allowed only value at date of destruction. The Board of Tax Appeals held with the taxpayers but the Circuit Court of Appeals reversed the Board's ruling.

Decision in No. 180 is governed by the Revenue Act of 1934; in No. 318 by the Revenue Act of 1932. The provisions of both statutes touching the question presented are substantially the same and we shall refer only to those of the 1934 Act. Section 23(e)(3) permits deduction from gross income of losses "of property not connected with the trade or business" of the taxpayer, "if the loss arises from . . . casualty." Subsection (h) declares that "The basis for determining the amount of the deduction for losses sustained, to be allowed under subsection (e) . . . , shall be the adjusted basis provided in section 113(b)." Section 113 is entitled "Adjusted basis for determining gain or loss"; in subsection (a) it provides that "The basis of property shall be the cost of such property," with exceptions not material. Subsection (b), to which 23(h) refers, is: "*Adjusted basis.* The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (1) *General rule.* Proper adjustment in respect of the property shall in all cases be made— . . . (B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income-tax laws."

The income tax acts have consistently allowed deduction for exhaustion, wear and tear, or obsolescence only in the case of

"property used in the trade or business." The taxpayers in these cases could not, therefore, have claimed any deduction on this account for years prior to that in which the casualty occurred. For this reason they claim they may deduct upon the unadjusted basis,—that is,—cost. As the income tax laws call for accounting on an annual basis; as they provide for deductions for "losses sustained during the taxable year"; as the taxpayer is not allowed annual deductions for depreciation of non-business property; as section 23(h) requires that the deduction shall be on "the adjusted basis provided in section 113(b)," thus contemplating an adjustment of value consequent on depreciation; and as the property involved was subject to depreciation and of less value in the taxable year, than its original cost, we think section 113 (b)(1)(B) must be read as a limitation upon the amount of the deduction so that it may not exceed cost, and in the case of depreciable non-business property may not exceed the amount of the loss actually sustained in the taxable year, measured by the then depreciated value of the property. The Treasury rulings have not been consistent, but this construction is the one which has finally been adopted.

In No. 180 judgment reversed.
In No. 318 judgment affirmed.

I.T. 4032

Bureau of Internal Revenue, 1950. 1950–2 Cum.Bull. 21.

Advice is requested as to the amount of loss deductible under section 23(e)(3) of the Internal Revenue Code, in the case of depreciable nonbusiness property, where such loss is partially covered by insurance.

Section 23(e)(3) of the Internal Revenue Code provides that in computing net income there shall be allowed as deductions:

(e) Losses By Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

* * * * * * * * *

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. * * *

It is held that the amount of loss which is deductible under section 23(e)(3) of the Code, *supra*, in the case of depreciable nonbusiness property, is the difference between the value of the property immediately preceding the casualty and its value (including salvage value) immediately after the casualty, but not in excess of an amount equal to the adjusted basis of the property, reduced by any insurance or other compensation received. In

other words, the amount of insurance or other compensation received must be applied to the amount of the loss otherwise determined, whether measured by the difference between the value of the property immediately before and immediately after the casualty, or limited to the adjusted basis of the property as provided in section 113(b) (1) of the Code.

Application of the above-stated conclusion is illustrated by the following examples:

Example 1. Residential property which cost $10,000 had a value of $18,000 immediately preceding the casualty. Immediately after the casualty, such property had no value. The amount recovered by way of insurance was $7,000.

Value of property immediately preceding casualty......	$18,000
Less: Value of property immediately after casualty....	0
Difference, but not in excess of cost (adjusted basis)...	10,000
Less: Insurance recovery..........................	7,000
Loss deductible under section 23(e)(3), I.R.C.........	3,000

Example 2. An automobile used for nonbusiness purposes which cost $3,000 had a value of $1,000 immediately preceding the casualty. Immediately after the casualty, the automobile had a value (including salvage value) of $100. The amount recovered by way of insurance was $700.

Value of automobile immediately preceding casualty....	$1,000
Less: Value of automobile immediately after casualty...	100
Difference, but not in excess of cost (adjusted basis)....	900
Less: Insurance recovery...........................	700
Loss deductible under section 23(e)(3), I.R.C..........	200

Notes

(A) Compare *Gilbert J. Kraus,* T.C.Memo. October 31, 1951, the facts in which may be simplified as follows:

A man owned a residence which had cost $10,000. Its value rose to $18,000, when it was completely destroyed by fire. Insurance was received in the amount of $7,000.

The Tax Court held that the deductible loss was $3,000—the difference between the $10,000 basis and the $7,000 insurance payment. The taxpayer argued that he should be entitled to deduct $10,000. His contention was that his overall loss was $18,000 (since there was no salvage value recoverable from the property after the fire). He then applied the $7,000 insurance payment against this, leaving, by his contention, a net loss of $11,000. His argument was that he could then deduct the lower of his net loss or basis. Since his basis was $10,000, that, he contended, was the measure of his loss in this case.

In rejecting this contention, the Tax Court said:

"Petitioner argues on brief that this [the Tax Court's method of determining the loss outlined above] is an incorrect method

of determining the loss. His argument is that, where the difference in the fair market values before and after the casualty minus any insurance or other compensation received by the taxpayer on account of such loss exceeds the adjusted cost basis, the amount of the actual loss sustained by the taxpayer is his adjusted cost basis without diminution thereof by any such insurance or other compensation. While it may be true that many a taxpayer in these days of inflated values thinks of a loss of his residence by fire, storm, or other casualty in terms of its market value on the date of loss, such is not the case for purposes of a loss deduction for income tax purposes under section 23. 'Actual loss sustained' is the rule laid down by the courts and not 'replacement value' which is what petitioner's argument amounts to. See Pioneer Cooperage Co., 17 B.T.A. 119 (1929) and cases cited therein, affd., 52 F.2d 43 (C.A.8, 1931), cert. den. 284 U.S. 686 (1932). If a replacement-value is more equitable than the present one, a change thereto must be made by the Congress and not by this tribunal."

(B) *Alcoma Ass'n, Inc. v. United States,* 239 F.2d 365 (C.A. 5th, 1956), involved a taxpayer who owned a citrus grove which was partially destroyed by a hurricane. The fair market value of the grove after the hurricane was $191,000 less than the fair market value of the property before the hurricane, and the loss represented 12% of the fair market value before the hurricane. The adjusted basis of the property before the hurricane was $523,000. The Commissioner allowed as a deduction for the loss 12% of $523,000, or $62,760. The taxpayer claimed the entire loss as a deduction, or $191,000. The court held that the taxpayer was entitled to deduct the actual reduction in market value, not in excess of its basis. Consequently, a deduction of $191,000 was allowed. The court held that the taxpayer was not limited to a pro rata part of the basis for its deduction. There is a comment on the case in 70 Harv.L.Rev. 1481 (1957).

(C) A person living near a river sustains a loss to his house in a flood disaster. The Red Cross gives him a grant to help him replace his house. The amount of this grant must be taken into account in determining the amount of his loss deduction. See special ruling in 1952 Prentice-Hall Federal Tax Service, par. 76,171. The result is similar when an employer makes a payment to an employee to help him replace a home which was destroyed in a tornado. Rev.Rul. 131, 1953–2 Cum.Bull. 112.

Bad Debts

Sec. 166 of the 1954 Code, and secs. 1.166 through 1.166–8 of the Income Tax Regulations

Until 1942, the provision which is now found in sec. 166 of the 1954 Code allowed a deduction for "debts ascertained to be worthless and charged off during the taxable year." This language raised a good many problems as both the charge-off and the ascertainment of worthlessness had to occur in the same year. The Commissioner could defeat the deduction by showing that the debt became worthless in some other year. Since 1942,

the language has allowed the deduction of "any debt which becomes worthless within the taxable year." This still leaves the difficult question of determining the year in which the debt actually becomes worthless.[1] At the same time, however, the provision now found in sec. 6511(d) was added to the Code, providing a special seven-year statute of limitations with respect to claims for refund based on the deduction of bad debts. This has the effect of enabling the taxpayer to get a deduction in some year within the seven year period.

Note

Where a debt is secured, and the security remains of more than nominal value, the debt need not be deducted as worthless, even though the security is worth less than the face amount of the debt. *Loewi v. Ryan,* 229 F.2d 627 (C.A.2d, 1956), noted in 69 Harv.L.Rev. 1507 (1956), 65 Yale L.J. 1045 (1956), and in 25 Geo.Wash.L.Rev. 113 (1956).

Partially worthless debts. Note that a partially worthless business debt can be deducted, to the extent charged off by the taxpayer on his books, under sec. 166(a)(2).

Reserve for bad debts. Under sec. 166(c), the bad debt deduction may be taken, with the approval of the Treasury, through "a reasonable addition to a reserve for bad debts." How does this deduction operate? See *H. W. Porter & Co., Inc.,* 14 T.C. 307 (1950), dealing with some of the factors affecting an addition to a bad debt reserve, and holding a claimed addition to be proper. See also *S. W. Coe & Co. v. Dallman,* 216 F.2d 566 (C.A.7th, 1954), where the average experience over the past five years was applied. Can such a deduction be "precise," a mere matter of mathematical computation? If not, is it any the worse for it? For a discussion, see "Reasonable Additions to a Reserve for Bad Debts for Tax Purposes," 14 Louisiana L.Rev. 588 (1954).

In Mim. 6209, 1947–2, Cum.Bull. 26, the Commissioner has authorized banks to compute their reserve for bad debts on the basis of their experience over a twenty year period. What is the reason for such a ruling? The mimeograph is discussed in Vernon, "Bad Debt Reserves for Banks," 4 Tax L.Rev. 53 (1948). See also O'Meara, "Mimeograph 6209 and the Ceiling on Bad Debt Reserves for Banks," 19 U. of Cin.L.Rev. 1 (1950); Severson, "A Survey of the Economics of Allowances for Bad Debts on Loans Held by Commercial Banks," 19 U. of Cin.L.Rev. 15 (1950).

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[1] See Gillette, "Debts Which Become Worthless Within the Taxable Year," 23 Taxes 972 (1945); Green, "When Can a Bad Debt or Worthless Security Be Claimed as a Tax Deduction?" 84 J. of Accountancy 216 (1947).

Under sec. 271 of the 1954 Code, no deduction is allowed on account of the worthlessness of any debt owed by a political party. This is designed to overcome a practice which had grown up under which a taxpayer might lend a large sum to a political organization, and then deduct it as a bad debt. In this way, taxpayers sought to get a deduction for what was in substance a nondeductible campaign contribution. This provision of the 1954 Code originated in an amendment made to the 1939 Code in 1952. See Bloom, "Tax Results of Political Contributions," 36 B.U.L. Rev. 170 (1956).

Nonbusiness debts. Sec. 166(d) contains a special provision with respect to nonbusiness debts. When such debts become worthless, they are treated as short term capital losses, which means that they can only be deducted to the extent of $1,000 a year, or used to offset capital gains, with a five year carry-over of any capital loss which cannot be deducted. For discussions, see "Nonbusiness Bad Debts: Loss Deductions for Quasi-Investors," 63 Yale L.J. 862 (1954); Guterman, "Some Problems in the Deduction of Bad Debts," 63 Harv.L.Rev. 832 (1950); Friedman, "Bad Debts: Business or Non-Business?" 5 Tax L.Rev. 412 (1950).

Note the special provision in sec. 166(f) with respect to guarantors of individual loans. See "Sec. 166(f) of the I.R.C.: Bad Debts and Confusion Guaranteed," 65 Yale L.J. 247 (1955).

Suppose a person owning all the stock of a corporation makes an advance of money to the corporation, which the corporation is eventually unable to repay. Is such an advance a loan, or a contribution to the capital of the company? May the stockholder take a deduction for a bad debt on the part of the advance which is not repaid? See *Alfred R. Bachrach v. Commissioner,* 205 F.2d 151 (C.A.2d, 1953). See Kamens and Ancier, "Tax Treatment of Advances by Stockholders," 28 Taxes 1049 (1950). See also Eaton, "Guaranty Payment where Debtor No Longer Exists: Loss or Bad Debt?" 31 Taxes 222 (1953).

Cf. *Ewing v. Commissioner,* 213 F.2d 438 (C.A.2d, 1954), where the taxpayer was interested in ballet. She owned a considerable amount of stock in a ballet theater, and made a series of advances to it. It was held that she did not act from a profit motive, that these were personal expenses, and that no deduction was allowable, not even as a non-business bad debt.

PUTNAM v. COMMISSIONER

Supreme Court of the United States, 1956. 352 U.S. 82.

MR. JUSTICE BRENNAN delivered the opinion of the Court.

The petitioner, Max Putnam, in December 1948, paid $9,005.21 to a Des Moines, Iowa, bank in discharge of his obligation as guarantor of the notes of Whitehouse Publishing Company. That corporation still had a corporate existence at the time of the payment but had ceased doing business and had disposed of its assets eighteen months earlier. The question for decision is whether in the joint income tax return filed by Putnam and his wife for 1948, Putnam's loss is fully deductible as a loss "incurred in [a] transaction . . . for profit, though not connected with [his] trade or business" within the meaning of § 23 (e)(2) of the Internal Revenue Code of 1939 [corresponding to Sec. 165(c)(2) of the 1954 Code], or whether it is deductible only as a short-term capital loss, because a nonbusiness bad debt within the meaning of § 23(k)(4) of the [1939] Code [corresponding to Sec. 166(d) of the 1954 Code].

The Commissioner determined that the loss was a non-business bad debt to be given short-term capital loss treatment. The Tax Court and the Court of Appeals for the Eighth Circuit sustained his determination. Because of an alleged conflict with decisions of the Courts of Appeals of other Circuits we granted certiorari.

Putnam is a Des Moines lawyer who in 1945, in a venture not connected with his law practice,[1] organized Whitehouse Publishing Company with two others, a newspaperman and a labor leader, to publish a labor newspaper. Each incorporator received one-third of the issued capital stock but Putnam supplied the property and cash with which the company started business. He also financed its operations, for the short time it was in business, through advances and guarantees of payment of salaries and debts. Just before the venture was abandoned, Putnam acquired the shares held by his fellow stockholders and in July 1947, as sole stockholder, wound up its affairs, and liquidated its assets. The proceeds of sale were insufficient to pay the full amount due to the Des Moines bank on two notes given by the corporation and guaranteed by Putnam for moneys borrowed in August 1946 and March 1947.

The familiar rule is that *instanter* upon the payment by the guarantor of the debt, the debtor's obligation to the creditor becomes an obligation to the guarantor, not a new debt, but, by

[1] Petitioners abandoned in this Court the alternative contention made below that the loss was deductible in full as a business bad debt under § 23(k) (1).

subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps into the creditor's shoes. Thus, the loss sustained by the guarantor unable to recover from the debtor is by its very nature a loss from the worthlessness of a debt. This has been consistently recognized in the administrative and the judicial construction of the Internal Revenue laws which, until the decisions of the Courts of Appeals in conflict with the decision below, have always treated guarantors' losses as bad debt losses. The Congress recently confirmed this treatment in the Internal Revenue Code of 1954 by providing [Sec. 166(f)] that a payment by a noncorporate taxpayer in discharge of his obligation as guarantor of certain noncorporate obligations "shall be treated as a debt."

There is then no justification or basis for consideration of Putnam's loss under the general loss provisions of § 23(e)(2), *i. e.,* as an ordinary nonbusiness loss sustained in a transaction entered into for profit. Congress has legislated specially in the matter of deductions of nonbusiness bad debt losses, *i. e.,* such a loss is deductible only as a short-term capital loss by virtue of the special limitation provisions contained in § 23(k)(4). The decision of this Court in *Spring City Co. v. Commissioner,* 292 U.S. 182, is apposite and controlling. There it was held that a debt excluded from deduction under § 234(a)(5) of the Revenue Act of 1918 was not to be regarded as a loss deductible under § 234(a)(4). Chief Justice Hughes said for the Court:

"Petitioner also claims the right of deduction under § 234(a)(4) of the Act of 1918 providing for the deduction of 'Losses sustained during the taxable year and not compensated for by insurance or otherwise.' We agree with the decision below that this subdivision and the following subdivision (5) relating to debts are mutually exclusive. We so assumed, without deciding the point, in *Lewellyn v. Electric Reduction Co.,* 275 U.S. 243, 246. The making of the specific provision as to debts indicates that these were to be considered as a special class and that losses on debts were not to be regarded as falling under the preceding general provision. What was excluded from deduction under subdivision (5) cannot be regarded as allowed under subdivision (4). If subdivision (4) could be considered as ambiguous in this respect, the administrative construction which has been followed from the enactment of the statute—that subdivision (4) did not refer to debts—would be entitled to great weight. We see no reason for disturbing that construction." 292 U.S., at 189.

Here also the statutory scheme is to be understood as meaning that a loss attributable to the worthlessness of a debt shall be regarded as a bad debt loss, deductible as such or not at all.

The decisions of the Courts of Appeals in conflict with the decision below turn upon erroneous premises. It is said that the guarantor taxpayer who involuntarily acquires a worthless debt is in a position no different from the taxpayer who voluntarily acquires a debt known by him to be worthless. The latter is treated as having acquired no valid debt at all.[2] The situations are not analogous or comparable. The taxpayer who voluntarily buys a debt with knowledge that he will not be paid is rightly considered not to have acquired a debt but to have made a gratuity. In contrast the guarantor pays the creditor in compliance with the obligation raised by the law from his contract of guaranty. His loss arises not because he is making a gift to the debtor but because the latter is unable to reimburse him.

Next it is assumed, . . . that a new obligation arises in favor of the guarantor upon his payment to the creditor. From that premise it is argued that such a debt cannot "become" worthless but is worthless from its origin, and so outside the scope of § 23(k). This misconceives the basis of the doctrine of subrogation, apart from the fact that if it were true that the debt did not "become" worthless, the debt nevertheless would not be regarded as an ordinary loss under § 23(e). *Spring City Co. v. Commissioner, supra.* Under the doctrine of subrogation, payment by the guarantor, as we have seen, is treated not as creating a new debt and extinguishing the original debt, but as preserving the original debt and merely substituting the guarantor for the creditor. The reality of the situation is that the debt is an asset of full value in the creditor's hands because backed by the guaranty. The debtor is usually not able to reimburse the guarantor and in such cases that value is lost at the instant that the guarantor pays the creditor. But that this instant is also the instant when the guarantor acquires the debt cannot obscure the fact that the debt "becomes" worthless in his hands.

Finally, the Courts of Appeals found support for their view in the following language taken from the opinion of this Court in *Eckert v. Burnet,* 283 U.S. 140:

"The petitioner claims the right to deduct half that sum as a debt 'ascertained to be worthless and charged off within the taxable year,' under the Revenue Act of 1926, c. 27, § 214(a)(7); 44 Stat. 9, 27.

"It seems to us that the Circuit Court of Appeals sufficiently answered this contention *by remarking that the debt was worthless when acquired. There was nothing to charge off.* The petitioner treats the case as one of an investment that later turns out to be bad. But in fact it was the satisfaction of an existing obligation of the petitioner, having, it may be, the consequence

[2] Reading Co. v. Commissioner, 132 F.2d 306; W. F. Young, Inc. v. Commissioner, 120 F.2d 159; American Cigar Co. v. Commissioner, 66 F.2d 425.

of a momentary transfer of the old notes to the petitioner in order that they might be destroyed. It is very plain we think that the words of the statute cannot be taken to include a case of that kind." 283 U.S., at 141. (Emphasis added.)

That statement did not imply a determination by this Court that the guarantor's loss was not to be treated as a bad debt. This Court was not faced with the question in *Eckert*. The point decided by the case was that a guarantor reporting on a cash basis and discharging his guaranty, not by a cash payment, but by giving the creditor his promissory note payable in a subsequent year, was not entitled to a bad debt loss deduction in the year in which he gave the note. The true significance of the quoted language is that although "the debt was worthless when acquired" it could not "be charged off" within the taxable year as the promissory note given for its payment was not paid or payable within that year.[4]

The objectives sought to be achieved by the Congress in providing short-term capital loss treatment for nonbusiness bad debts are also persuasive that § 23(k)(4) applies to a guarantor's nonbusiness debt losses. The section was part of the comprehensive tax program enacted by the Revenue Act of 1942 to increase the national revenue to further the prosecution of the great war in which we were then engaged. It was also a means for minimizing the revenue losses attributable to the fraudulent practices of taxpayers who made gifts to relatives and friends disguised as loans. Equally, however, the plan was suited to put nonbusiness investments in the form of loans on a footing with other nonbusiness investments. The proposal originated with the Treasury Department whose spokesman championed it as a means "to insure a fairer reflection of taxable income," [5] and the House Ways and Means Committee Report stated that the objective was "to remove existing inequities and to improve the procedure through which bad-debt deductions are taken." [6] We may consider Putnam's case in the light of these revealed purposes. His venture into the publishing field was an investment apart from his law practice. The loss he sustained when his stock became worthless as well as the losses from the worthlessness of the loans he made directly to the corporation would receive capital loss treatment; the 1939 Code so provides as to nonbusiness losses both from worthless stock investments and from loans to a corporation, whether or not the loans are evi-

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4 See Helvering v. Price, 309 U.S. 409. The requirement that the debt "be ascertained to be worthless and be charged off within the taxable year" was superseded in the Revenue Act of 1942, § 124(a), by the requirement that the debt be one which "becomes worthless within the taxable year."

5 Hearings before House Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d Sess. 90.

6 H.R.Rep.No.2333, 77th Cong., 2d Sess. 44.

denced by a security. It is clearly a "fairer reflection" of Putnam's 1948 taxable income to treat the instant loss similarly. There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same, and are accomplished by § 23(k)(4). The judgment is

Affirmed.

[A dissenting opinion by MR. JUSTICE HARLAN is omitted.]

Notes

(A) There are comments on the *Putnam* case in 57 Col.L.Rev. 577 (1957) and 25 Geo.Wash.L.Rev. 613 (1957). See also Brown, "Putnam v. Commissioner—The Reimbursable Outlay under The Tax Law," 6 Buffalo L.Rev. 283 (1957).

For discussions of the problem, preceding the *Putnam* decision, see Holzman, "The Current Trend in Guaranty Cases: An Impetus to Thin Incorporation," 11 Tax L.Rev. 29 (1955); Guigon, "Unwarranted Tax Advantages in Corporate Finances—Shareholders Guaranteed Loans," 30 St. John's L.Rev. 35 (1955).

(B) Compare *Tony Martin,* 25 T.C. 94 (1955), in which the Commissioner has published his acquiescence. 1956-1 Cum.Bull. 4. In this case, the taxpayer had been in the entertainment business before he entered the Army in 1942. When he came out of the Army in 1945, he wanted to appear in a picture in order to re-establish himself. For this purpose, he undertook to produce a picture himself. He organized a corporation, and advanced money to it on notes. The picture was not a financial success, and the notes became worthless. The Court held that the taxpayer could take a business bad-debt deduction.

Small business corporations. Compare the provision of sec. 1244 of the Code allowing the deduction in full of losses on "small business corporation" stock, as defined and limited in that section. Under this provision, a person embarking on a new venture may make his investment in stock, and deduct his entire loss if the investment turns out unfavorably—to the extent and subject to the provisions of sec. 1244. See Nicholson, "Section 1244 Stock," 38 Taxes 303 (1960). See also secs. 1242 and 1243 of the Internal Revenue Code of 1954.

Depreciation and Related Deductions

Secs. 167–169, 171, 611–616 of the 1954 Code

Regulations have been issued under sec. 167 of the 1954 Code as secs. 167(a)-1 through 167(h)-1 of the Income Tax Regulations.

Regulations have been issued under secs. 168 and 169 of the 1954 Code as secs. 1.168–1 through 1.169–8 of the Income Tax Regulations.

Proposed Regulations under secs. 611 through 616 of the 1954 Code have been issued as secs. 1.611–1 through 1.616–3 of the proposed Income Tax Regulations.

Depreciation is, of course, not a concept which is peculiar to the income tax field. It is simply an accounting device designed to aid in the process of allocating aggregate costs to the periods with respect to which income is allocated for various purposes, including taxes. In *Lindheimer v. Illinois Bell Telephone Co.,* 292 U.S. 151, 167 (1934), the Court said: "Broadly speaking, depreciation is the loss not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence." The nature of depreciation is also discussed at length in the dissenting opinion of Mr. Justice Brandeis in *United Railways v. West,* 280 U.S. 234, 255 (1930).[1] See also Macrae, "Tax Depreciation—We're Doing It the Hard Way," 11 Tax Exec. 226 (1959); Graves, "Depreciation for Tax Purposes," 34 Taxes 59 (1956).

HELVERING v. F. & R. LAZARUS & CO.

Supreme Court of the United States, 1939. 308 U.S. 252.

MR. JUSTICE BLACK delivered the opinion of the Court.

In computing its net taxable income for 1930 and 1931, respondent claimed depreciation on three buildings occupied and used in its business as a department store. During those years, the legal title to two of these properties and an assignment of a ninety-nine year lease to the third were in a bank as trustee for certain land-trust certificate holders. These properties had been transferred to the trustee by the respondent in 1928 and the trustee had at the same time leased all three back to the respondent for ninety-nine years, with option to renew and purchase. In claiming the deduction, respondent insisted that the capital loss from wear, tear, and exhaustion of the buildings was falling upon it, thus entitling it to the statutory allowance for depreciation of buildings. The Commissioner disallowed this deduction on the ground that the statutory right to depreciation follows legal title. Reviewing the evidence, the Board of Tax Appeals concluded that the transaction between respondent and the trustee bank was in reality a mortgage loan and ordered the deduction allowed, and the Circuit Court of Appeals affirmed. Up-

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1 For general consideration of the tax problems of depreciation, see Grant and Norton, Depreciation (1955).

on facts which it considered "in all essential respects identical," the Court of Appeals for the District of Columbia held depreciation not allowable. Because of the different results reached by the Courts of Appeal, we granted certiorari.

The Federal income tax is aimed at net income determined from gross income less items such as necessary expenses incurred or capital consumed in earning it. Thus, the controlling statute permits a taxpayer in computing net income to deduct a "reasonable allowance for . . . exhaustion, wear and tear." While it may more often be that he who is both owner and user bears the burden of wear and exhaustion of business property in the nature of capital, one who is not the owner may nevertheless bear the burden of exhaustion of capital investment. Where it has been shown that a lessee using property in a trade or business must incur the loss resulting from depreciation of capital he has invested, the lessee has been held entitled to the statutory deduction.[1]

Here, the taxpayer used business property in which it had a depreciable capital investment, provided it had not recovered its investment through a sale. The Board in substantial effect found that the instrument under which the taxpayer purported to convey legal ownership to the trustee bank was in reality given and accepted as no more than security for a loan on the property; the "rent" stipulated in the concurrently executed ninety-nine year "lease" back was intended as a promise to pay an agreed five per cent interest on the loan; and the "depreciation fund" required by the "lease" was intended as an amortization fund, designed to pay off the loan in forty-eight and one-half years. These findings are supported by evidence which permits, at most, conflicting inferences and are, therefore, conclusive here. And, unless the Board committed error of law we must affirm.

We think the Board justifiably concluded from its findings that the transaction between the taxpayer and the trustee bank, in written form a transfer of ownership with a lease back, was actually a loan secured by the property involved. General recognition has been given the "established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money."[2] In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are

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1 Duffy v. Central R. Co. of N. J., 268 U.S. 55; Appeal of Gladding Dry Goods Co., 2 B.T.A. 336, 338; Cogar v. Commissioner, 44 F.2d 554. See, Bowman Co. v. Commissioner, 32 F.2d 404, 405; Nat'l City Bank of Seattle v. United States, 64 Ct.Cls. 236, cert. den. 276 U.S. 620; Commissioner v. H. F. Neighbors Realty Co., 81 F.2d 173.

2 Peugh v. Davis, 96 U.S. 332, 336; Hughes v. Edwards, 9 Wheat. 489, 495; Russell v. Southard, et al., 12 How. 139; Teal v. Walker, 111 U.S. 242. See cases collected in 79 A.L.R. 937.

not rigidly binding. Congress has specifically emphasized the equitable nature of proceedings before the Board of Tax Appeals by requiring the Board to act "in accordance with the rules of evidence applicable in courts of equity of the District of Columbia." 26 U.S.C. 611.

The Government relies in part upon *Senior v. Braden,* 295 U.S. 422. Whatever the significance of that case, it can have no application here. In the *Braden* case, the equitable doctrine—here controlling—of looking to extrinsic evidence behind a transfer absolute on its face to determine whether only a security transaction was contemplated by the parties, was neither invoked nor passed upon.

Judgment below is

Affirmed.

Notes

(A) In 1919, X owned land which she leased to Y for 66 years. In accordance with the terms of the lease, Y erected a building on the land, with a useful life of 50 years. In 1940, X died, and T, the taxpayer, inherited the property. An estate tax was paid on X's estate which included a value for the property in question obtained by capitalizing the annual rental under the lease. It was held that T had no investment in the building and was not entitled to any deduction for depreciation. *Albert L. Rowan,* 22 T.C. (1954), following *Commissioner v. Pearson,* 188 F.2d 72 (C.A. 5th, 1951), cert. den. 342 U.S. 861 (1951), and *Commissioner v. Moore,* 207 F.2d 265 (C.A.9th, 1953), cert. den. 347 U.S. 942 (1954). See "Lessee-Erected Improvements Securing Long-Term Leases: An Overlooked Depreciation Deduction for the Landlord," 63 Yale L.J. 872 (1954); Young, "The Tax Consequences of Real Estate Financing," 1957 U. of Ill.L.Forum 360.

(B) When a tenant erects a building or installs improvements, is he entitled to a depreciation deduction? Should the amount of the deduction be determined by the life of the improvements, or by the duration of his term, if that is shorter? See *Ehrlich v. Commissioner,* 198 F.2d 158 (C.A.1st, 1952) (tenant for annually renewable one year periods); *Penn v. Commissioner,* 199 F.2d 210 (C.A.8th, 1952), cert. den. 344 U.S. 927 (1953) (life tenant). See Wolden, "Amortization of Leasehold Improvements," 35 Taxes 83 (1957).

Where the lease requires the tenant to make replacements which immediately become the property of the lessor, it has been held that the lessee can deduct the entire cost of the replacements in the year they are acquired. *Journal-Tribune Publishing Co. v. Commissioner,* 216 F.2d 138 (C.A.8th, 1954). Presumably the tenant would not thereafter be able to deduct depreciation with respect to such property.

This question is now extensively covered by sec. 178 of the 1954 Code, which was newly enacted by sec. 15 of the Technical Amendments Act of 1958.

(C) Under sec. 167 the depreciation deduction is applicable to "property used in the trade or business" or "held for the produc-

tion of income." Suppose the property is inactive, or in storage, or otherwise not actually being utilized in the business. Is a deduction for its depreciation allowable? It has been held that such a deduction can be taken, but that the basis of the property must be adjusted whether the deduction is taken or not—in other words, that the deduction must be taken. *P. Dougherty Co. v. Commissioner*, 159 F.2d 269 (1946), cert. den. 331 U.S. 838 (1947); *Kittredge v. Commissioner*, 88 F.2d 632, 634 (C.C.A.2d, 1937); *Yellow Cab Co. v. Driscoll*, 24 F.Supp. 993 (W.D.Pa. 1938).

(D) The problem of conversion of ordinary income into capital gain by means of depreciating assets below their realistic salvage value has recently been the subject of a series of cases involving automobile rental agencies, which regularly sell their cars after only a year or two of use. Under sec. 167(c), the declining value, and other special methods, can only be used when the "property" has "a useful life of 3 years or more." Likewise, the "useful life" affects the salvage value which must be taken into account in computing depreciation. Should the "useful life" be the whole period in which the automobile has value as such, or merely the shorter period during which it will be retained by the company as a rental car?

The Commissioner has issued Regulation Section 1.167(a)–1 (b), which adopts the latter definition of "useful life," and this view was upheld by the Supreme Court. *Massey Motors, Inc. v. United States*, — U.S. — (1960). What is the tax avoidance possibility about which the Commissioner is concerned?

Note that there is no serious problem if the court finds that the automobiles were held primarily for sale to customers in the ordinary course of business, because the gain realized when the assets are sold for a sum in excess of adjusted basis will then be taxed at the ordinary income rates. *Charlie Hillard*, 31 T.C. 961 (1959). In the similar situation of new car dealers' demonstrator models, the courts appear likely to take this approach. *Duval Motor Co. v. Commissioner*, 264 F.2d 548 (C.A.5th, 1959); *United States v. Massey Motors, Inc.*, 264 F.2d 552, 553, footnote 1 (C.A.5th, 1959) (dictum). See, in general, Morris, "Salvage: The First Decisions as the New I.R.S. Positions Come Before the Courts," 10 J. Taxation 258 (1959); Note, 12 Vand.L.Rev. 449 (1959).

Methods for Determining Depreciation

It is obvious that the amount of depreciation actually sustained cannot be computed precisely. Some method of estimating or approximating the result must be used.[1] Until 1954, the statute prescribed no method for tax purposes, simply providing that "a reasonable allowance" should be made for depreciation. Under sec. 167(b) of the 1954 Code, three methods are expressly provid-

[1] For general discussions, see Fischer, "Methods of Depreciation: A Review," 31 Taxes 681 (1953); Brundage, "Depreciation—An Old Subject with a New Importance," 13 Harv.Bus.Rev. 334 (1935).

ed or authorized, two of them, though, only with respect to assets acquired new after January 1, 1954.[2] These are:

(1) *The straight line method.* This was the usual method prior to the 1954 Code. Under it the useful life of the property is estimated, and the cost of the property, less salvage, is spread in equal annual installments over the life of the property. Thus, if the useful life is estimated to be ten years one tenth of the cost, less salvage, is deducted in each of the ten years. This method has the merit of simplicity.

(2) *The declining balance method.* Under this, a constant percentage is used, but it is applied each year to the amount remaining after the depreciation of previous years has been charged off. Under sec. 167(b)(2) the rate used in this method cannot be more than twice that under the straight line method. Thus if property has a useful life of ten years, a rate up to 20% may be used. Assuming a cost of $1,000, and ignoring salvage, depreciation in the amount of $200 could be deducted the first year. This would leave $800 as the undepreciated cost remaining. In the second year the 20% rate applied to the $800 remaining cost would give a depreciation deduction of $160; in the third year the depreciation deduction would be $128, and so on. The deduction declines each year but will never run out entirely as long as the property remains in use. This method has been allowed to a limited extent by the Treasury for the past several years. See I.T. 3818, 1946–2 Cum.Bull. 42. See Rothschild, "The Case for the Declining Balance," 33 Taxes 502 (1955); Conrad, "Varying Rapidity Factors in Rapid Depreciation," 35 Taxes 594 (1957).

(3) *The sum of the digits method.* Under this method, the useful life of the property is determined, and then a sum is made of all the digits going to make up that number of years. Thus, if the useful life of the property is ten years, the sum of the digits is 10+9+8+7+6+5+4+3+2+1 which equals 55. In the first year depreciation is allowed in the amount of $^{10}/_{55}$ of the cost, in the second year in the amount of $^{9}/_{55}$ of the cost, and so on, down to $^{1}/_{55}$ in the tenth year.

Both of these newer methods result in an increased depreciation in the earlier years, and a lower amount of depreciation in the later years. In neither case will the aggregate amount of depreciation be affected over the entire useful life of the property. In the long run, the new methods should not really make much difference if the taxpayer retains the property throughout its useful life. It is supposed that they will stimulate the purchase of new machinery and equipment in the immediate future. Whether this will actually work out, and how it will work out

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2 See Eisner, "Depreciation under the New Tax Law," 33 Harv.Bus.Rev. 66 (1955).

in the long run, is a question. Perhaps the companies which take the larger depreciation deductions will not be too happy when they get to the later years and find themselves with very small deductions. Suppose, for example, that there is an excess profits tax in effect during the later years.

Other methods of depreciation have also been in use. These include:

(4) *The annuity method.* This calls for placing a present value on each of the years of future usefulness, with corresponding charges against the operations in each of those years. This method ordinarily results in larger depreciation charges in the earlier years.

(5) *The sinking fund method.* This contemplates that the annual depreciation charges will be set aside in a fund at interest, and that the charges, together with the accumulated interest, will equal the cost of the property when its useful life has expired.

(6) *Retirement accounting.* A method which has long been used by the railroads, and perhaps by others, is known as retirement accounting. Under this method, no annual charges for depreciation with respect to an item of property are made. Nothing is taken into account until the property is "retired," at which time its entire cost is charged against income. An excellent decision discussing and applying this method is *Boston and Maine Railroad v. Commissioner*, 206 F.2d 617 (C.A.1st, 1953). In that case a building was largely destroyed by fire in 1937. It was retired in 1940, after consideration had been given to the possibility of rebuilding it, and permission for the retirement had been obtained from the Interstate Commerce Commission. See also *Akron, C. & Y. R. R.*, 22 T.C. 648 (1954), noted in 68 Harv.L.Rev. 546 (1955).

Note that this method largely supersedes the deduction for losses with respect to property under sec. 165, as well as sharply modifying the depreciation deduction. The general theory is that retirements will work out evenly over the years and that the method will give a good over-all approximation of annual income. Many problems have been encountered from change-overs from retirement to straight-line depreciation. These were dealt with in the Retirement-Straight Line Adjustment Act of 1958, by Sec. 94 of the Technical Amendments Act of 1958.

The depreciation deduction is designed to enable the taxpayer to recover the cost of property used in the trade or business, but no more than the cost. Is this adequate when, with increasing price levels, replacements now cost more than the property which

is being replaced? For consideration of the proper basis for depreciation in a time of inflation, see Brown, Effects of Taxation on Depreciation Adjustments for Price Changes (1952).

See Kirby, "Accelerated Depreciation and the Treasury Regulations," 54 Northwestern U.L.Rev. 434 (1959); Lassers, "The New Depreciation Regulations," 34 Taxes 741 (1956); Laird, "Accounting for Fixed Assets," 36 Taxes 629 (1958); Peters, "Deduction for Depreciation before Acquisition of the Asset," 36 Taxes 55 (1958); Brown, "The New Depreciation Policy under the Income Tax: An Economic Analysis," 8 Nat.Tax J. 81 (1955).[1]

COHN v. UNITED STATES

United States Court of Appeals, Sixth Circuit, 1958. 259 F.2d 371.

SHACKELFORD MILLER, Jr., CIRCUIT JUDGE.

The appellants, Bertrand W. Cohn, William R. Kent and Louise C. Kent, filed separate actions in the District Court against the United States of America for recovery of certain additional income taxes and interest thereon paid by them for the years 1942 through 1945, inclusive. The claims were based upon the alleged erroneous reduction by the Commissioner of Internal Revenue of certain depreciation deductions taken by the taxpayers in making their income tax returns for the years in question. Other claims on the part of the taxpayers were also made in the District Court actions, but the rulings with respect thereto are not involved in these appeals. The three actions were consolidated for hearing in the District Court. The District Judge entered separate judgments for the respective appellants which, however, by reason of his adverse ruling on the depreciation deductions, were substantially less than the appellants claimed, resulting in these three appeals. The basic facts and legal issues are the same in each case and the three appeals will, accordingly, be disposed of in this one opinion.

The material facts, about which there is no real dispute, were found by the District Judge as follows. The appellants were partners in three flying schools which were engaged in training pilots

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1 For further discussions of depreciation methods, see Graham and Katz, Accounting in Law Practice, sec. 132 (2d ed., 1938); Saliers, Depreciation Principles and Applications (3d ed., 1939); Kurtz, The Science of Valuation and Depreciation (1937); Hotelling, "A General Mathematical Theory of Depreciation," 20 J.Am.Statistical Ass'n 340 (1925); Kirkham, "Depreciation Under the Income Tax," 11 Accounting Rev. 345 (1936); May, "The Relation of Depreciation Provisions to Replacement," 69 J. of Accountancy 341 (1940); Brown, "Tax Allowances for Depreciation Based on Changes in the Price Level," 1 Nat.Tax J. 311 (1948); Manning, "Depreciation in the Tax Laws and Practice of the United States, Australia, Canada, Great Britain, New Zealand and South Africa," 1 Nat.Tax J. 154 (1948); Landman, "The Old and New Depreciation Problem," 25 Taxes 911 (1949).

under the Army Air Corps Contract Flying School Program. These schools were (1) Pine Bluff School of Aviation at Pine Bluff, Arkansas, hereinafter referred to as "Pine Bluff School", (2) Helena Aero Tech at Helena, Arkansas, hereinafter referred to as "Helena Aero School", and (3) Clarksdale School of Aviation at Clarksdale, Mississippi, hereinafter referred to as "Clarksdale School". The contracts under which the flying schools were operated were simply memorandum agreements whereby the Army Air Corps agreed to furnish the air planes and to pay a price of $17.50 per revenue hour flying time and the contractor agreed to furnish all facilities and personnel, under the supervision of an air corps detachment, necessary for the training of Cadets. The term of the contracts was for one year or from the beginning of the school until the following June 30, whichever term was shorter, and was cancellable without cause by the Army Air Corps on 30 days notice. No assurances of renewal or extension were made.

The appellants, who were responding to an emergency request from the Air Corps, were required to provide for an initial investment of $250,000 before commencing operation of the Pine Bluff School. This operation began on March 22, 1941. In the spring of 1941 appellants William R. Kent and Bertrand W. Cohn were contacted by R. A. Van Devere in regard to commencing a similar school at Helena, Arkansas. After some discussion, they became minority limited partners in the Helena Aero School, with Van Devere as general partner. This school began operation on October 16, 1941. In the spring of 1942 the appellants and Van Devere were asked to undertake equipping and operating a third school, which was constructed by them for the Defense Plant Corporation. This school, known as the Clarksdale School, commenced training pilots on July 1, 1942.

It was necessary for the operators of the schools to furnish all the needed movable assets for the operation of the schools on an expanded basis. Investments by the different schools at the peak of their operations in such equipment were $171,465.91 at Pine Bluff, $96,905.43 at Helena, and $92,343.77 at Clarksdale. The movable assets which made up this investment were divided into certain general classes: (a) Barracks equipment, including iron beds, linens, wooden chairs and blankets; (b) Mess hall equipment consisting of china, chairs, wooden tables and various cooking utensils; (c) Shop equipment consisting of tools and machinery; (d) A large sum invested in parachutes; (e) Fire fighting equipment of a special airport variety; (f) Ground school equipment, including maps, cutaway airplane engines and navigational instruments; (g) Office equipment, including desks, chairs, typewriters, and adding and bookkeeping machines; (h) Rolling equipment, consisting of trucks, buses, and automobiles.

In the latter part of 1942 the partners held a meeting in an effort to determine a proper method of depreciation of the movable assets of the schools during the existence of the Civilian Contract Flying Program. This meeting was also attended by the managers, bookkeepers and auditors of the three schools. Based upon a thorough investigation by the partners, including discussions with Air Corps personnel, it was finally determined that a target date of December 31, 1944, represented the reasonable maximum duration of the Civilian Contract School Program, and it was decided that the movable equipment other than the automobiles, regardless of the date of purchase, would be depreciated to this date. This method and rate of depreciation was based upon the useful economic life of the equipment in the business with the target date of December 31, 1944. Deductions for depreciation on this basis were taken by the appellants for income tax purposes for the tax years involved herein.

All of the contracts between the Air Corps and the partnerships were subject to renegotiation. The Army Renegotiation Board, consisting of representatives of the Treasury Department and the Air Corps, approved this method of computing depreciation as being a reasonable and proper operating expense under the contract and allowed the depreciation expense for renegotiation purposes.

On August 4, 1944, the Helena Aero School was terminated. On October 16, 1944, the Pine Bluff School and the Clarksdale School were terminated. Various methods of disposing of the movable equipment were considered. The partners learned that other schools had successfully auctioned this type of property. A professional auctioneer was engaged, who reconditioned the equipment, advertised the sales widely, and sold the equipment at good prices. One auction was held at Helena in August, 1944; another at Pine Bluff (including the Clarksdale School property) in November, 1944. Because of wartime shortages and price increases, the movable equipment at Pine Bluff School was sold at a net profit of $63,077.77. The equipment of the Helena Aero School was sold at a net profit of $40,207.57, and the movable equipment of the Clarksdale School was sold at a net profit of $38,631.58. Appellants reported this profit, which represented the excess of the sale price over the cost basis which remained on their books in the year of the sale, as income subject to the provisions of Sec. 117(j) of the Internal Revenue Code, 26 U.S.C.A. § 117(j), taxable as long-term capital gains.

The flight-training schools did not consider and take into account the salvage value of this movable equipment in determining the depreciation which they were claiming. Operators of

similar schools determined their depreciation allowances on the basis of a salvage value equal to 10 per cent of the original cost of such equipment.

Subsequent to the filing of the Federal Income Tax Returns for the years 1942, 1943, 1944 and 1945, the Commissioner took the position that the allowable depreciation should be computed upon a basis of a useful life of ten years for ground school, shop and canteen equipment, and five years for certain other types of equipment, including automobiles, trucks, barracks furniture and fixtures. He, accordingly, disallowed depreciation deductions by the three schools as follows: $16,377.06 by the Pine Bluff School for 1942, $16,188.13 by the Helena Aero School for 1942, $39,028.-96 by the Pine Bluff School for 1943, $23,748.48 by the Helena Aero School for 1943, $15,270.25 by the Clarksdale School for 1943, $21,888.75 by the Pine Bluff School for 1944, $7,900.12 by the Helena Aero School for 1944, $29,611.80 by the Clarksdale School for 1944. These disallowances resulted in assessments for additional income taxes against the partners in the respective schools, which were paid. Claims for refunds were filed and denied. The present actions were then filed in the District Court.

The District Judge made the following conclusions of law: (1) The appellants in depreciating the movable equipment of the flying schools over the period of the estimated useful economic life used a reasonable and proper method under the circumstances to reflect the value of the assets; (2) The appellants failed to establish that the movable equipment of the flight-training schools did not have some salvage value which could have been estimated at the end of 1941 or during 1942, 1943, and 1944; (3) The intensification of the war effort and the growing scarcity of goods made it reasonable for the schools to expect that the movable equipment would have some salvage value at the termination of their operation; and (4) The appellants, in determining a reasonable allowance for depreciation, should have taken into account an estimated net salvage value either through a reduction in the basis or a reduction in the rate of depreciation, and, under the circumstances, a salvage value equal to 10 per cent of the original cost of all the movable equipment of the three flying schools should have been taken into account in determining the annual allowance for depreciation. He held that subject to necessary adjustments to allow for salvage value equal to 10 per cent of the original cost of the movable equipment, the appellants were entitled to a refund, and ordered that a judgment in accordance with this ruling be entered within five days. . . .

On May 2, 1957, the District Judge made the following additional findings of fact. The partners knew in August, 1944, when the movable equipment of the Helena Aero School was sold, the price this equipment brought and thus at the end of the fiscal year

1944, they knew the actual salvage value of said movable equipment. The same was true as to the Pine Bluff School for its fiscal year ending September 30, 1945, and the Clarksdale School for its fiscal year ending June 30, 1945, as the sale of the movable equipment at these two schools took place in November, 1944; that prior to the close of its fiscal year ending September 30, 1944, the Pine Bluff School knew by reason of the sale in August, 1944, of similar items of equipment of the Helena Aero School that the probable salvage value of the Pine Bluff School's items of movable equipment would be approximately the same as in the sale of similar assets for the Helena Aero School; that the reasonably estimable salvage value of the movable equipment of the Helena Aero School and the Pine Bluff School at the end of the fiscal years 1944 and 1945 was the actual net salvage value of such equipment; and that the same was true as to the Clarksdale School for its fiscal year ending June 30, 1945.

Based on these findings the District Judge made the following additional conclusions of law: (1) Allowable depreciation is determined in the light of conditions known to exist at the end of the tax year; (2) Depreciation deductions are to be corrected in any year when it is obvious that a fact involving useful life is in error; (3) Where the actual salvage value of assets is known at the end of a tax year, depreciation is not allowable for that year on such assets to the extent that their book value at the beginning of the tax year is less than their actual salvage value; (4) No depreciation on the movable assets was allowable to the Helena Aero School for 1944 and to the Pine Bluff and Clarksdale Schools for the fiscal year 1945 to the extent that the actual salvage values at the end of such years were more than the book values of such equipment at the beginning of such year; (5) The actual salvage value of the movable equipment of the Pine Bluff School should be used in determining depreciation for its fiscal year ending on September 30, 1944, because it was known by reason of the prices at which similar equipment had been sold in the August, 1944, sale, that the actual salvage value resulting from the sale in November, 1944, and the reasonably estimable salvage value were the same. No depreciation on the movable equipment of this school was allowable as a deduction for the fiscal year 1944 to the extent that the salvage value which should have been used for such year was greater than the book or depreciated value of such equipment at the beginning of such year; (6) The gain or loss on the sale by the flight training schools of their movable equipment should be redetermined on the basis of the depreciation so allowed. He directed that the necessary adjustments be made in accordance with the findings and conclusions as amended. Such judgments were subsequently entered, from which these appeals were taken. . . .

Considering the merits, it appears that the parties are in agreement about the following well settled principles governing depreciation deductions. A reasonable allowance for depreciation of property used in the production of income may be deducted from gross income. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property. Useful life is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. Useful life is necessarily an estimate made at the time when the property is first put to its business use. Since it frequently happens that the property may still have some value when it has completed its usefulness to the business, which will be realized by the taxpayer by its sale at the end of its useful life, it is necessary that this salvage value be deducted from the cost in order to find the net amount which is to be amortized over the years the property is to be used in the business. Necessarily, salvage value is also an estimate made at the time when the asset is first subject to a depreciation allowance. *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648; *Virginian Hotel Corporation of Lynchburg v. Helvering,* 319 U.S. 523, 528; Mertens, Law of Federal Income Taxation, Vol. 4, Secs. 23.01, 23.04, 23.05, 23.17. If the asset is sold at a price in excess of its depreciated value, such excess is taxable in the nature of a capital gain. Sec. 117(j), Internal Revenue Code, 1939 ed.

It results from the application of the foregoing principles that an increase in the depreciation allowance means a lower net income and a larger amount taxable as a capital gain. Since a long-term capital gain is limited to a tax of twenty-five per cent thereof, it is to the appellants' interests in this case that the depreciation deductions claimed in their returns be approved instead of being reduced as contended for by the Commissioner.

The District Judge in his original ruling applied the foregoing principles. He approved the shorter period of useful life used by the appellants and rejected the Commissioner's contention for the longer period. On the other hand, he required the appellants in computing depreciation to take into consideration the salvage value of the equipment at the end of its useful life, which the appellants had not done, and fixed this salvage value at 10 per cent of cost. This lowered to a small extent the depreciation deductions claimed by the appellants but left them in amounts much larger than fixed by the Commissioner's rulings. The appellants now acquiesce in those rulings of the District Judge. The Government has taken no appeal from the ruling on useful life. We

probably would not have had the present appeal if the District Judge had not made his additional findings of fact and conclusions of law based thereon.

By his supplemental findings the District Judge materially increased the salvage value of the movable assets from 10 per cent of cost to conform to the value shown by the auction sales to actually exist. Since this increased salvage value exceeded the remaining depreciated value of the assets, the assets automatically became 100 per cent depreciated, with the necessary resulting ruling that the depreciation deductions then being claimed by the appellants were disallowed. Appellants contend that the District Judge was in error in making such increase in salvage value.

Even on this phase of the case the disagreement between the parties is limited to a narrow field. There is no disagreement about the following legal principles. It often happens that the estimated useful life of an asset is shown by the passage of years to be substantially incorrect, and in cases where at the end of any taxable year there is a clear and convincing basis, in the light of facts reasonably known to exist at the time, for making a redetermination of the remaining useful life of the asset, such a redetermination may be made. If a redetermination is made, the depreciation is not modified for prior years, but the remaining depreciated cost is spread ratably over the new estimated remaining useful life and depreciation reductions taken accordingly for the current and succeeding years. *Commissioner of Internal Revenue v. Mutual Fertilizer Co.*, 5 Cir., 159 F.2d 470; *Commissioner of Internal Revenue v. Cleveland Adolph Mayer Realty Corp.*, 6 Cir., 160 F.2d 1012; Mertens, Law of Federal Income Taxation, Vol. 4, Sec. 23.47. See: *The Copifyer Lithograph Corp.*, 12 T.C. 728.

The narrow issue remaining is appellants' contention that although remaining useful life may be redetermined at the end of any taxable year on the basis of facts reasonably known to exist at the end of such taxable year, it is not permissible to redetermine the estimated salvage value because of subsequent appreciation in market values. They state in their brief that "Salvage value is an estimated figure, determined at the date of acquisition of depreciable property, and mere fluctuation in market value does not justify an adjustment in this figure." Practical considerations are stated in support of this contention such as the resulting continuous changes in depreciation allowances as salvage values are adjusted from year to year according to the fluctuations up and down of market values, the appalling increase in costs to both the taxpayer and the Government in maintaining and examining a set of books reflecting such changes, and the necessity of negotiations between the taxpayer and the Internal Revenue Service for each

taxpayer for each year in which depreciation is claimed. There is merit to the contention as so stated.

But the Government is not contending that salvage value should be adjusted annually in order to conform with current market values, or that it should be adjusted at all on account of "mere fluctuation in market value." In so far as this case is concerned the issue is whether salvage value can be adjusted at or near the end of the useful life of the asset when it is shown by an actual sale of the asset that there is a substantial difference between what was estimated and what it actually is. We are not concerned with mere fluctuations or with any fluctuations from year to year. On the contrary, we have a single and final adjustment in the closing of the books on the asset involved. Under such circumstances the practical difficulties urged upon us are largely nonexistent.

We still have left, however, appellants' fundamental contention that salvage value, having been determined at the time of acquisition, can not be redetermined at any time thereafter. The authorities cited by the respective parties on this exact issue are not very helpful. We are not referred to any Supreme Court ruling or case from this Circuit which decides the question. There are a number of Tax Court rulings which deal with the correctness of an original determination of salvage value by the taxpayer or the failure of the taxpayer to give any consideration to salvage value in claiming a depreciation deduction. We have a different problem here.

On the basis of the settled principles hereinabove referred to, we do not agree with appellants' contention. Depreciation involves a combination of useful life and salvage value, both estimated. If, under certain circumstances, depreciation can be reconsidered through a redetermination of useful life, it would seem logical to permit, at least at the same time, a reconsideration and redetermination of salvage value. Since a change in the depreciation allowance is not applied retroactively, such a change in the salvage value would not affect prior taxable years. . . .

This question was not specifically covered by the Internal Revenue Regulations under the 1939 Code but is covered by Sec. 1.167(a)-1 under the 1954 Code. Appellants state that the present Regulations are expressive of the rule as it existed under the 1939 Code. They rely upon the statement in Sec. 1.167(a)-1(c) that "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels." We believe appellants fail to give due consideration to the word "merely" used therein. As pointed out above, minor fluctuations in market values from year to year

should no doubt be disregarded. It should also be pointed out that immediately after the sentence relied upon, the Regulations also state: "However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life."

Appellants, in filing their actions in the District Court, put in issue the depreciation deductions claimed by them and disallowed by the Commissioner. In deciding that issue under the circumstances of this case, we are of the opinion that the District Judge was not in error as a matter of law in considering both useful life and salvage value. If so, his findings of fact with respect to salvage value are fully supported by the evidence, are not clearly erroneous, and must be sustained.

The judgments are affirmed.

Notes

(A) Note especially the provisions of sec. 1.167(a)–1(c) of the Income Tax Regulations, which was upheld in *Hertz Corp. v. United States,* —— U.S. —— (1960). The Treasury's active interest in salvage in connection with depreciation is fairly recent. Prior regulations were not as specific as this one.

(B) Suppose that the property had been sold for considerably less than its adjusted basis. Does this mean that there should be no "loss" on the sale, but that depreciation for the year of sale should be adjusted by taking the full difference between adjusted basis and sale price as a depreciation deduction in that year? [1]

(C) *Additional first year depreciation allowance.* Sec. 179 which was added to the Code by the Small Business Tax Revision Bill of 1958 allows a deduction of 20% of the cost of tangible personal property in the year in which it is acquired. The property may be new or used, but it must be business property with a useful life of six years or more. The aggregate amount of property which is eligible is $10,000, or $20,000 in the case of joint returns. Since the deduction under this section is based on cost, no allowance need be made for salvage value.

Intangible property. How far may a depreciation deduction be taken with respect to intangible property? See sec. 1.167(a)–3 of the Income Tax Regulations. The answer is ordinarily not difficult with respect to intangible rights like patents or copyrights which become exhausted after a fixed period. Cf. sec. 1.167(a)–6(a) of the Income Tax Regulations. The Regulations specifically

1 For general consideration, see Taynton, "Effect of Salvage Value on Depreciation," 36 Taxes 97 (1958).

state that no deduction may be taken for the depreciation of good will. Is this a proper regulation?

Leaseholds. Suppose the taxpayer becomes the lessee of property. Is he entitled to any deduction for exhaustion of the lease? Suppose he buys the lease from someone else who was the original lessee. Would the result be different? Suppose the taxpayer inherits land which is subject to an advantageous outstanding lease. Is he entitled to a deduction for exhaustion as the lease expires? See *Friend v. Commissioner,* 119 F.2d 959 (C.C.A.7th, 1941), cert. den. 314 U.S. 673 (1941), and *Rosalie M. Schubert,* 33 T.C. ––– (1960), where such a deduction was denied. However, in *Commissioner v. Moore,* 207 F.2d 265 (C.A.9th, 1953), the court refused to follow the *Friend* case, and allowed an amortization deduction in such a case. *Cf. Hort v. Commissioner,* set out at p. 198, above.

Would the result be different if what the taxpayer inherited was itself a leasehold interest which had been advantageously subleased for the balance of the term? An amortization deduction was allowed in such a case in *Estate of John W. F. Hobbs,* 16 T.C. 1259 (1951). The Commissioner has published his nonacquiescence. 1951–2 Cum.Bull. 5.

Similar problems arise with respect to rights to receive payments from a partnership after the death of a partner, royalties, and other interests. For a general consideration, see Lourie and Cutler, "Wasting Assets—The Treatment of and a Proposal for," 6 Tax.L.Rev. 409 (1951). See also Rubin, "Depreciation of Property Purchased Subject to a Lease," 65 Harv.L.Rev. 1134 (1952).

Obsolescence. Sec. 167 expressly allows the deduction of "a reasonable allowance for obsolescence." What is the difference between obsolescence and depreciation? In *Real Estate-Land Title & Trust Co. v. United States,* 309 U.S. 13, 15–17 (1940), in denying a deduction for obsolescence, the Court said: "Now it is true that in the popular sense a thing which is obsolete is one which is no longer used, a meaning which gives color to petitioner's claim for deduction since there is no question that the title plan here involved is no longer utilized to any degree whatsoever. But the term 'allowance for obsolescence,' as used in the Act and in the Treasury Regulations, has a narrower or more technical meaning than that derived from the common, dictionary definition of obsolete. . . . The Court, without undertaking a comprehensive definition, has held that obsolescence for purposes of the revenue acts 'may arise from changes in the art, shifting of business centers, loss of trade, inadequacy, supercession, prohibitory laws and other things which, apart from physical deterioration, operate to cause plant elements or the plant as a whole to suffer diminution in value.' . . . But not every decision

of management to abandon facilities or to discontinue their use gives rise to a claim for obsolescence. For obsolescence under the Act requires that the operative cause of the present or growing uselessness arise from external forces which make it desirable or imperative that the property be replaced." [3]

For further discussion of obsolescence, see sec. 1.167(a)-9 of the Income Tax Regulations.

Basis for depreciation. Sec. 167(f) provides that the basis for determining depreciation shall be "the adjusted basis provided in section 1011." See also sec. 1.167(f)-1 of the Income Tax Regulations. This will be developed more fully in the later chapter dealing with capital gains and losses.

Amounts Received as Contributions or Subsidies

One important question which has caused some difficulty is now covered by the statute. *Detroit Edison Co. v. Commissioner,* 319 U.S. 98 (1943), involved a situation where customers of a utility paid for the poles and lines required to bring them service. The company owned the property but the cost had been borne by the customer. It was held that the company could not take any deduction for depreciation.

In *Brown Shoe Co. v. Commissioner,* 339 U.S. 583 (1950), the situation was slightly different. There the taxpayer had received payments of cash or the transfer of buildings from various community groups in towns in which it conducted manufacturing operations. These were given under contracts, and were designed to induce the taxpayer to locate or to remain in the towns and to provide employment there. The Supreme Court held that the taxpayer was entitled to deduct depreciation on the buildings received, and on the full cost of property acquired with the contributed cash. For a discussion (prior to the 1954 law), see Freeman and Speiller, "Tax Consequences of Subsidies to Induce Business Location," 9 Tax.L.Rev. 255 (1954).

See also *Teleservice Co. of Wyoming Valley v. Commissioner,* set out at pages 181–188, above.

This matter is now covered by **sec. 362(c)** of the 1954 Code, which provides that the basis shall be zero in such cases, thus eliminating any depreciation deduction. (Sec. 362(c) is in subchapter C, and thus included in the reference made in sec. 1011, which in turn is referred to in sec. 167(f)). See also, sec. 1.362-2 of the Income Tax Regulations.

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3 See Troxel, "Economic Influences of Obsolescence," 26 Am.Econ.Rev. 280 (1936); Whittaker, "Economic Considerations of Obsolescence," 12 Accounting Rev. 337 (1937); [May], "Obsolescence of Good Will," 49 J. of Accountancy 161 (1930), also in May, Twenty-Five Years of Accounting Responsibility II, 295 (1936).

Related Deductions

Amortization. During World War II a section was added to the 1939 Code (sec. 124) providing a deduction for the amortization of war facilities. This allowed the amortization of the cost of emergency defense facilities over a period of five years or less in case the President proclaimed the ending of the emergency period within a shorter time. This provision was of great importance to taxpayers who built war plants or bought war machinery. It enabled them to deduct the cost during the period of excess profits taxation, which was, presumably, the period during which the facilities would be most used. (This deduction is the one which has often been referred to in the press as "fast tax write-offs.") On September 29, 1945, the President proclaimed the end of the emergency period. Problems relating to the ending of the amortization period are discussed in Mim. 5957, 1945 Cum.Bull. 181.

With the outbreak of the Korean emergency, Congress added a new amortization provision to the 1939 Code, in sec. 124A. This was similar in purpose and effect to the earlier one, but refined and developed considerably in detail. This provision is now carried forward into sec. 168 of the 1954 Code. There is a similar provision in sec. 169 of the 1954 Code with respect to the amortization of the cost of grain storage facilities.

Amortizable bond premium. A wholly different deduction, though with a similar name, is that for amortizable bond premium, provided by sec. 171 of the 1954 Code. In most cases, this deduction is optional. It is rather complicated, but is of importance to banks and other taxpayers which have a considerable amount of bonds bought at a premium. It has no application to bonds bought at a discount.

A number of questions have arisen under this deduction, and some loopholes have had to be closed. In *Commissioner v. Korell,* 339 U.S. 619 (1950), it appeared that the taxpayer had bought convertible bonds at a substantial premium. The premium was due almost entirely to the conversion feature. The bonds were immediately callable (although they were not in fact called), and the taxpayer deducted the entire amount of the premium. (Then after holding the bonds for six months, he could sell and take the gain as a long term capital gain.) The Supreme Court allowed the deduction under the statute as it then stood. This led to the addition to the statute (in 1950) of the language now found in the last sentence of sec. 171(b)(1).

It next developed that bonds were available which were selling at a substantial premium, had no conversion feature, and were immediately callable—although no one expected them to be called. A considerable market developed for these bonds as they were

bought, premium deducted, and then sold for a capital gain after being held for six months. To meet this situation, language was added to sec. 171(b) (1) (B), and the provision was further amended in 1958.

Under sec. 171(d), the term "bond" means any evidence of indebtedness of a corporation bearing interest. This overrules Rev. Rul. 54–66, 1954–1 Cum.Bull. 128, under the earlier statute which had held that an instrument was not a bond for purpose of amortization of premium unless it was issued with interest coupons or in registered form.

Note the provisions of sec. 75, relating to dealers in tax exempt securities. This was amended by the Technical Amendments Act of 1954, adding provisions designed to make it more difficult for a dealer to derive tax exempt interest income while at the same time sustaining a deductible loss.

Depletion

Sec. 611–616 of the 1954 Code, and secs. 1.611–1 through 1.616–3 of the Income Tax Regulations

Depletion is a concept which is closely related to that of depreciation. It is designed to make allowance for the value of capital consumed in the process of producing income. There could be no possible objection to the deduction if it was limited to the recovery of the capital actually invested.

The 1909 Act made no provision for a deduction for depletion. In *Stratton's Independence v. Howbert*, 231 U.S. 399 (1913), the Court found no difficulty with this and held the taxpayer was not entitled to any allowance for depletion. The 1913 Act allowed a deduction for depletion not in excess of five per cent of the value of the product mined. This was upheld in *Stanton v. Baltic Mining Co.*, 240 U.S. 103 (1916), against a showing that the actual depletion sustained was in excess of five per cent. From this extreme, Congress has gone to the other so that there are now few groups of taxpayers so favored as those who can take depletion deductions.

This development began with the allowance of "discovery depletion" at the time of World War I. Under this provision, the taxpayer was entitled to recover through depletion not his cost but the value of the mine or well within a short period after the discovery of mineral or oil there. This obviously allowed a great increase in the aggregate amount of depletion deduction available, and allowed the taxpayer to recover an amount in excess of his cost.

The next step was "percentage depletion," which came in 1924. This is now allowed by sec. 613 of the 1954 Code. In the case of wells and mines, it is often extremely difficult to determine the

proportion of the total deposit which has been extracted in any particular year. The allowance of a percentage would be quite justifiable, if it was based on the cost, or on some other item (perhaps even including "discovery value"). But the percentage depletion actually allowed is a percentage of the gross income from the property (limited by a percentage of the net income), and this deduction goes on without limit, and without regard to the recovery of the cost or of the discovery value or anything else. It is simply an annual deduction (in the case of oil and gas wells) of 27½% of the gross income, but not in excess of 50% of the taxable income from the property. (Other percentages are applicable, as prescribed in sec. 613(b), for other types of property.)

Efforts to restrict the depletion deduction have been consistently unsuccessful. In fact it is such a good thing that it is being constantly extended to other items, as may be seen by examining the list now included in sec. 613. It may be that the provision is justifiable as a subsidy to the oil and mining industries. In its present form, however, it obviously bears no relation to the determination of the net income actually derived from oil and mining activities.

For an examination of the questions from two points of view, see Baker and Griswold, "Percentage Depletion—A Correspondence," 64 Harv.L.Rev. 361 (1951). See also Hughes, "Percentage Depletion," 37 Taxes 883 (1959); Galvin, "The Deduction for Percentage Depletion and Exploration and Development Costs," in 2 Tax Revision Compendium (Committee on Ways and Means) 933 (1959); Freeman, "Percentage Depletion for Oil—A Policy Issue," 30 Ind.L.J. 399 (1955); "The Depletable Status of an Assigned Net Profit Payment," 11 Southwestern L.J. 62 (1957); Bruen, "Federal Income Tax Aspects of Oil and Gas Ventures—A Summary for the Investor," 14 Tax L.Rev. 353 (1959).[1]

Only a person who has "an economic interest in the oil, in place," or other mineral, is entitled to depletion. *Palmer v. Bender*, 287 U.S. 551, 557 (1933). See also *Helvering v. Bankline Oil Co.*, 303 U.S. 362, 367 (1938). Thus, where a taxpayer carried out a contract for strip mining coal from the lands of

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[1] For earlier discussions, see Eldridge, "Tax Incentives for Mineral Enterprises," 58 J.Pol.Econ. 222 (1950); Eldridge, "Extractive Industries and the Excess Profits Tax," 4 Nat.Tax J. 315 (1951); Baker, "The Nature of Depletable Income," 7 Tax L.Rev. 267 (1952); Macleod, "Percentage Depletion Controversy," 99 J. of Accountancy 40 (1955); Lasseigne, "Depletion of Oil and Gas Properties Under Federal Income Tax Law," 25 Tulane L.Rev. 112 (1949); Draper, "Percentage Depletion and Alternative," 60 Harv.L.Rev. 606 (1947); Appleman, "Taxation of Net Profits from Oil and Gas Properties," 23 Tex.L.Rev. 347 (1945); Rabkin and Johnson, "The Income Tax on Oil and Gas Interests," 90 U. of Pa.L.Rev. 383 (1942).

others, it was held that no depletion deduction was allowable against the amounts received under the contracts. *Parsons v. Smith,* 359 U.S. 215 (1959).

Intangible drilling costs. Though it has no direct connection with the depletion deduction, it is relevant to consider here the deduction which is allowed for so-called intangible drilling costs. When an oil well is drilled, there are certain expenses. Some of these are for tangible property—a derrick, a shed, a source of power and so on. These expenses are treated in the usual way. Their cost is recovered through a depreciation deduction. But a large part of the expense is put into a hole in the ground. This is not a thing—it is the absence of anything. The cost of drilling the hole is referred to as "intangible drilling expense."

Under regulations which have long been in force by the Treasury, the taxpayer has an option either to deduct or to capitalize intangible drilling costs. If they are capitalized, they are recoverable only through the depletion deduction. But this is a fixed deduction bearing no relation to the actual capital cost, so the depletion deduction is not increased if the intangible drilling costs are captalized. So of course they are deducted as an expense. Thus the taxpayer is allowed to deduct all of his production costs *and* take percentage depletion as well. The option to deduct intangible drilling costs is now expressly sanctioned by the statute. See sec. 263(c) of the 1954 Code.

For consideration of the general question, see Galvin, "The 'Ought' and 'Is' of Oil-and-Gas Taxation," 73 Harv.L.Rev. 1441 (1960); Bergen, "Oil and Taxes—Some Problems and Proposals," 26 So.Calif.L.Rev. 396 (1953). See also Breeding and Burton, Taxation of Oil and Gas Income (1954); Miller, "The Intangible Deduction," 100 J. of Accountancy 40 (1955); Stroud, "Option to Deduct Intangible Drilling and Development Expenses," 43 A.B.A.J. 553 (1957).

Exploration and development expenditures. In the case of minerals other than oil or gas, exploration expenditures (which might otherwise have to be capitalized) may be deducted up to $100,000 a year, under sec. 615 of the 1954 Code. Since the deduction might not always be useful to the taxpayer before he began to receive income from the property, he is also given the option, under sec. 615(b), to spread the deduction over the period of production. It will be noted that sec. 615(a) makes it relatively cheap for a wealthy taxpayer to carry on exploration for minerals.

Similarly, under sec. 616, the taxpayer may deduct all of the expenses of developing a mine (other than an oil and gas well)

after minerals have been discovered. Again the taxpayer has the option of spreading these expenses over the period of production.

For a consideration of this question (prior to the adoption of these provisions in the 1954 Code), see Alexander and Grant, "Mine Development and Exploration Expenditures," 8 Tax L. Rev. 401 (1953).

"Ordinary treatment processes." In the case of minerals, the percentage depletion deduction is not limited to the value of the mineral itself, as it is taken from the ground. Under Section 613(c) of the 1954 Code, "gross income from the property," in the case of mining, included not merely the extraction of the ore "but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products." In the case of clay a number of lower courts held that the "commercially marketable mineral product" was the tile or brick. *United States v. Cherokee Brick and Tile Co.,* 218 F.2d 424 (C.A.5th, 1955); *United States v. Sapulpa Brick and Tile Corporation,* 239 F.2d 694 (C.A.10th, 1956). The question also arose with respect to cement, where it was held that the "commercially marketable mineral product" is the finished cement. See *Dragon Cement Co. v. United States,* 244 F.2d 513 (C.A.1st, 1957).

In *United States v. Cannelton Sewer Pipe Co.,* —— U.S. —— (1960), The Supreme Court took a narrower view, and held that mining stops when the mineral is "in such state that [it is] ready for industrial use or consumption." At the same time, Congress changed the statute to provide the narrower rule for the future. See sec. 613(c) of the Code, as amended by the Act of June 30, 1960.

Note

Consider the following, which is quoted from the Brief of the Plaintiff-Appellant in the *Dragon Cement Company* case, cited above:

Percentage depletion, of course, has nothing to do with the recovery of the taxpayer's investment in the mineral property. It is a deduction, a subsidy if you wish, granted by Congress in the interest of the national economy to encourage the production of certain vital ores and minerals. See Rabkin & Johnson, Section 46.06 (quoted below *).

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* Rabkin & Johnson, Federal Income, Gift and Estate Taxation, Section 46.06:

"Percentage depletion has from its inception been a politically controversial issue. It has been attacked as a special industry subsidy with the primary profit of the mineral producing regions. It has been defended as a savior of our natural resources. It was originally justified as a simple short cut sub-

Charitable Contributions

Sec. 170 of the 1954 Code, and secs. 1.170–1 through 1.170–3 of the Income Tax Regulations

In the 1939 Code, there were two principal provisions allowing the deduction of charitable contributions. These were sec. 23(*o*) for individuals, and sec. 23(q) for corporations. These have been combined in sec. 170 of the 1954 Code. For many years the limitation on the deduction for individuals was 15% of the adjusted gross income. This was changed to 20% in 1952, and to the present arrangement which allows 20% generally, but an additional 10% in the case of gifts to churches, schools and hospitals, in 1954.

In the case of corporations, the limitation on the amount of the charitable contribution deduction is 5% of taxable income. There is, however, a two-year carry-over for corporations of any unused deduction. Sec. 170(b)(2).

Note that neither individuals nor corporations may take a deduction for a charitable contribution in excess of the percentage limitations, on the ground that it is a business expense. Sec. 162 (b).

For many years, the statute has included a provision allowing an unlimited charitable contribution deduction in the case of an individual who has given away substantially all of his income (after taxes) for a period of at least ten years. This is now included, with some modifications, in sec. 170(b)(1)(C) of the 1954 Code. This provision was amended by the Act of February 15, 1956, so as to allow a 100 per cent deduction for charitable

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stitute for the complicated cost depletion deduction. That defense has been made less tenable by the developing complications of percentage depletion itself, by the fact that cost depletion must in any case be computed for basis adjustments and by the further fact that a taxpayer would generally compute both cost and percentage depletion to determine which was more advantageous.

"The most valid justification for percentage depletion involves a criticism of one of the underlying assumptions of our income tax. As a general rule, with capital gains the major exception, every type of income bears the same amount of tax; the tax varies with the amount of income but not with the degree of risk involved in creating it. The dollar earned in oil wildcatting would but for percentage depletion pay the same tax as the dollar earned on a 3 per cent U. S. Savings Bond. The absurd surtax rates in the upper brackets are enough to discourage even mild speculation. The question is how many persons would incur the extreme risk of oil drilling or mine exploration if the net rewards or successes were as low as they would be in the absence of percentage depletion 'subsidy'? This kind of thing, of course, leads to alternatives. Either the principle of percentage depletion should be extended to other forms of risk income, or tax rates generally should be reasonable enough to encourage risk capital."

contributions, when the taxpayer has given at least 90 per cent of his income for charitable organizations for eight out of the last ten years. Note, too, that a trust or estate is entitled to an unlimited deduction for property "paid or permanently set aside" for a charity. Sec. 642(c) of the 1954 Code.

I. T. 3918

Bureau of Internal Revenue, 1948. 1948-2 Cum.Bull. 33.

Advice is requested whether an owner of property who grants permission to use and occupy the property to an organization described in section 23(o) of the Internal Revenue Code is entitled to deduct, in his Federal income tax return, the value of such use and occupancy.

The taxpayer in the instant case is the owner of certain property which he has heretofore rented for a substantial amount. For the year 1948, the taxpayer has not rented the property but has granted the use and occupancy thereof to an organization described in section 23(o) (2) of the Code.

Section 23(o) (2) of the Code provides in part that in computing net income there shall be allowed as deductions, in the case of an individual, contributions or gifts *payment* of which is made within the taxable year to or for the use of a corporation, trust, or community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, etc., to an amount not in excess of 15 per cent of the taxpayer's adjusted gross income.

It is the view of this office that permission to use and occupy property granted to an organization described in section 23(o) of the Code does not represent a *payment* made to or for the use of the organization within the meaning of that section. Such an arrangement does not constitute a gift of property. It is merely the granting of a privilege for which no charge is made.

Accordingly, it is held that the owner of property who grants permission to use and occupy the property to an organization described in section 23(o) of the Code is not entitled to deduct, in his Federal income tax return, an amount representing the value of such use and occupancy.

Notes

(A) A person who contributes his services to a charity and incurs unreimbursed traveling expenses in connection with his work for the charity may deduct such expenses, subject, of course, to the limitations provided in the Code. Rev.Rul. 55–4, 1955–1 Cum.Bull. 291.

(B) Note that the percentage limitation is applied to the "adjusted gross income" defined in sec. 62. However, a net operating loss deduction (because of a loss in some other year) does not reduce adjusted gross income for this purpose. Earlier rulings to the contrary, under the 1939 Code (Rev.Rul. 54–56, 1954–1 Cum.Bull. 64; Rev.Rul. 287, 1953–2 Cum.Bull. 21), are overruled by the 1954 statute.

(C) Under sec. 170(b)(1)(D) no deduction is allowed for a gift in trust where the grantor retains a reversary interest in the property which is worth more than 5% of the value of the property. Why was this provision necessary, or desirable? Note the provision in sec. 673(b) under which the grantor of a trust is not taxable on the income where it is payable to a charity for a period of two years or more.

(D) An individual may deduct a charitable contribution only in the year actually paid, even though he may keep his accounts on the accrual basis. Sec. 170(a)(1) of the 1954 Code. A corporation on the accrual basis may elect to deduct a payment approved in the taxable year and actually paid within two months and fifteen days thereafter. Sec. 170(a)(2). If the election is once made, it cannot thereafter be changed by filing an amended return. *Alabama Pipe Co.,* 23 T.C. 95 (1954).

(E) *United States v. Benedict,* 338 U.S. 692 (1950), involved the unlimited deduction allowed to trusts for income paid or set aside for charity, under what is now sec. 642(c) of the 1954 Code. The trust realized capital gains all of which were permanently set aside for charity. Under a provision analogous to that now found in sec. 1202 of the 1954 Code, only half of the gains were taken into account in computing the trust's gross income. The trust sought to deduct the entire amount of the gain since that amount was permanently set aside for charity. It was held that only half of the gain was deductible. This result is, in effect, now provided for in the next to the last sentence of sec. 642(c).

(F) What are the limits of the phrase "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation"? Is this a desirable limitation? See Devine, "Pioneers or Propagandists?" 29 Survey Graphic (1940); Clark, "The Limitation on Political Activities: A Discordant Note," 46 Va.L.Rev. 439 (1960). The Treasury's approach to this question was outlined in a statement by Assistant Commissioner Norman A. Sugarman before the Special Committee of the House of Representatives to Investigate Foundations, printed in the Internal Revenue Bulletin, June 21, 1954, p. 19. See sec. 1.501(c)(3)–1 of the Income Tax Regulations. See also Sacks, "The Role of Philanthropy: An Institutional View," 46 Va.L.Rev. 516 (1960).

A gift to the League of Women Voters was held not deductible in *League of Women Voters v. United States*, 180 F.Supp. 379 (Ct.Cls.1960). But a bequest to the Association of the Bar of the City of New York was allowed as an estate tax deduction in *Dulles v. Johnson*, 273 F.2d 362 (C.A.2d, 1959).

(G) What is the meaning or scope of the phrase "created or organized in the United States" in sec. 170(c)(2)(A) of the 1954 Code? Does this limit the deduction to gifts which are to be used in the United States? Are gifts for foreign missions, or for projects in Israel, deductible? Suppose the domestic organization acts primarily as a conduit for the funds to the foreign enterprise. See sec. 1.170–2(a)(1) of the Income Tax Regulations; House Report No. 1860, 75th Congress, 3d Sess., pp. 19–20.

In the case of corporate gifts, the deduction is allowed only if the gift "is to be used within the United States or any of its possessions." Sec. 170(c)(2).

Suppose a man buys property for $1,000. It increases in value to $5,000, and he gives it to a charity. Is this a realization of the gain, so that he has taxable income—on the ground that he can stick out his chest $5,000 worth, and not as a mere $1,000 donor? How much can he deduct in his income tax return? *Cf.* Report of the Sub-Committee of the Committee on Ways and Means (1938) 48; House Report No. 1860, 75th Congress, 3d Session (1938) 20; Senate Report No. 1567, 75th Congress, 3d Session (1938) 14. See Lasser, "Increasing Charitable Deduction by Gifts Other Than Cash," 95 J. of Accountancy 701 (1953).

Where a charitable gift is to be made it will always be advantageous to make it in appreciated property if the donor has such property available. Because of the deductibility of gifts made in appreciated property at their fair market value at the time of the gift, it is sometimes possible to be better off after making a gift to charity than if the property had been sold, and the proceeds, after capital gains tax, had been retained. How can this be? For a general discussion, see Seidman, "Save by Giving," 30 Taxes 338 (1952); Koch, "The Treasury's Bargain Counter: Contributions," 33 Taxes 249 (1955). See also Penick, "Tax Economics of Charitable Giving," 38 Taxes 111 (1960).

For those who are interested, the formula which shows when a donor may be better off by making a gift than by selling the property and keeping the proceeds is as follows:

The *Value* of the property

$$\text{must exceed } Basis \times \frac{.25}{\text{Donor's top tax rate minus .75}}$$

(These figures are applicable when the maximum capital gains tax rate is 25%. If that changes, corresponding adjustments must be made in the figures in the formula.)

See, generally, Lowndes, "Tax Advantages of Charitable Gifts," 46 Va.L.Rev. 394 (1960); Quiggle and Myers," Tax Aspects of Charitable Contributions and Bequests by Individuals," 28 Ford-

ham L.Rev. 579 (1960); Merritt, "The Tax Incentives for Charitable Giving," 36 Taxes 646 (1958); Palmer, "Tax Saving Through Charitable Giving," 36 Taxes 40 (1958).

Net Operating Loss Deduction

Sec. 172 of the 1954 Code; see also sec. 382(a) and (b); and secs. 1.172–1 through 1.172–8 of the Income Tax Regulations

The first provision for carrying over a deduction of a net loss was included in sec. 204(a) of the Revenue Act of 1918. Section 204(b) of the same act allowed a loss for the year 1919 to be carried back to the year 1918. The carry-over of operating losses was allowed as a deduction for many years thereafter. In 1924, the carry-over period was extended to two years. In 1932, the carry-over was cut down to one year; and the National Industrial Recovery Act in 1933 eliminated it entirely. A two year carry-over of losses was restored in 1939; and a two year carry-back was added in 1942.

This system remained in effect until 1950 when the carry-back was shortened to one year, and the carry-over was extended to five years. In the 1954 Code, the carry-back period was again fixed at two years, with the carry-over remaining at five years.

In 1958, the carry-back period was extended to three years by an amendment to sec. 172 made by the Technical Amendments Act of 1958. Thus, the total period which may be taken into what in effect is a single account (in the sense that no more business income will be taxed than the aggregate net income over the period) is now nine years, that is, three years of carry-back, the taxable year in which the loss occurs, and five years of carry-over.

In general, the net operating loss deduction is simply a deduction, like other deductions. Where the facts exist so that the deduction is available it is taken into account in computing the taxable income of the taxpayer, and thus in determining his tax liability. Of course, where the loss is sustained in a year following the taxable year in question, the deduction can ordinarily be taken only by filing a claim for refund to recover the tax already paid for the prior year.[2]

Note the provision of sec. 6611(f) of the 1954 Code under which no interest is allowed on a refund due to a carry-back except from the close of the taxable year in which the loss is sustained.

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[2] Under sec. 6164 of the 1954 Code, a corporation expecting a net operating loss can obtain a postponement of the payment of its tax for the immediately preceding year.

DIAMOND A CATTLE CO. v. COMMISSIONER

United States Court of Appeals, Tenth Circuit, 1956. 233 F.2d 739.

HUXMAN, CIRCUIT JUDGE. This case is here on petition for review of a decision of the Tax Court, under Sections 1141 and 1142 of the Internal Revenue Code of 1939 (now Internal Revenue Code of 1954, §§ 7482 and 7483, 26 U.S.C.A. §§ 7482, 7483). The taxpayer is a corporation which until mid-1945 was engaged in an extensive livestock business, with some farming incidental to the livestock operation. It and its predecessor had engaged in this business as a corporation since 1906, owning or leasing nearly one million acres of land in New Mexico and South Dakota. All of the stock of the company was acquired by Leon A. Williams on July 27, 1944, and the company began liquidation on August 14, 1945, by a transfer of all of its assets to the sole shareholder. Since that time the Diamond A Company has continued existence only for the purpose of winding up its affairs, including this controversy which began prior to the liquidation.

. . .

The appeal presents two questions: (1) Was the petitioner on an accrual system of accounting and hence properly required to report all income on that basis? (2) Was petitioner entitled to a carryback of excess profits credits and its reported net operating loss for 1945?

[The court held that the taxpayer was on the accrual basis.]

The second question relates to the right of the taxpayer to take advantage of the carryback of operating loss and excess profits credit provisions of the statute. Section 122(b)(1) of the 1939 Code provides: "If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years * * *." And Section 710(c)(3)(A) of the 1939 Code provides: "If for any taxable year beginning after December 31, 1941, the taxpayer has an unused excess profits credit, such unused excess profits credit shall be an unused excess profits credit carry-back for each of the two preceding taxable years * * *."

Taxpayer seeks the benefits of these provisions under the following facts. It began liquidation of the corporation on August 15, 1945, by transferring substantially all of its assets to the sole shareholder. Thereafter it did no business except pay a few debts and carry on the instant law suit. For the 7½ months in 1945 in which it operated its business it showed a net operating loss on the cash basis of $337,671.38. It attempts to carry back this operating loss and corresponding excess profits credits to the year 1943.

The evidence showed that petitioner made sales of livestock, in the first 7½ months of 1945 in the amount of only $878.50 and that virtually all of its sales of livestock are customarily made between September 1 and December 31 of each year. It may be presumed that had petitioner continued business throughout the remainder of the year and made normal sales it would have shown a net profit or at least a very greatly reduced loss.

The Commissioner contends that the carryback provisions never contemplated relief to taxpayers in this particular situation. In support of this position we are cited to statements in the legislative history showing that Congress in the passage of these two sections had in mind hardship cases and relief from true economic loss.

Petitioner's president and sole shareholder testified to various business reasons of liquidating at the time it did, including the uncertainty of business conditions at the end of the war, double taxation of corporate profits and the benefits of dealing with purchasers of cattle and creditors as an individual; but he admitted that he had tax benefit considerations in mind when he picked the time at which to liquidate. Since he was a certified public accountant of vast experience, it may be inferred that these benefits were important in his considerations in liquidating the corporation which belonged to him alone. But in our view such motives have no place in considering the question presented for our determination. It is too well settled to need citation of authorities that it is no offense nor it is reprehensible to avoid the attachment of taxes. One may employ all lawful means to minimize taxes. Petitioner takes the position the statute is clear and unambiguous and that the words thereof should be given the clear meaning which they import. No cases are cited having the identical factual situation presented here. However, there are cases which have considered this statute. In *Wier Long Leaf Lumber Co. v. Commissioner,* 5 Cir., 173 F.2d 549, the carryback provision was considered as applying to a corporation in liquidation but continuing in business. The court refused to go behind the wording of the statute to an examination of legislative history. In *Mesaba-Cliffs Mining Co. v. Commissioner,* 6 Cir., 174 F.2d 857, the almost identical words of the carry-over of excess profits credits were said to be entirely clear and unambiguous, and it was held that they should be read in their natural and ordinary sense.

It is certainly true that this petitioner has taken the maximum advantage of this situation taxwise, and this was probably a situation never contemplated by Congress. But as said by the Supreme Court in *Lewyt Corp. v. Commissioner,* 349 U.S. 237, 240, 75 S.Ct. 736, 739, 99 L.Ed. 1029, "where the benefit

claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall." When Congress passes an act in language that is clear and unambiguous, and construed and read in itself can mean but one thing, the act must be judged by what Congress did and not by what it intended to do.

We affirm the Tax Court in its finding and determination that the taxpayer was at all times on the accrual basis of accounting for income tax purposes, but we think it erred in denying the taxpayer the benefits of the carryback of the excess profits credit provision of the statute and the net operating loss for 1945. The conclusions we have reached make it necessary to reconsider the benefits, if any, to which the taxpayer may be entitled under the carry-back provisions of the statute by virtue of our holding that it is not entitled to deduct the item of interest as a cash item in the year in which the interest was paid. The decision appealed from is, therefore, vacated and the cause is remanded to the Tax Court for its further consideration of the taxpayer's additional tax liability, if any.

Notes

(A) In *American Well and Prospecting Co. v. Commissioner*, 232 F.2d 934 (C.A.3d, 1956), a corporation was engaged in selling oil well equipment. In 1946 it ceased operations, and all of its liabilities and obligations were assumed by another company. Its corporate existence continued, however, and it thereafter settled certain claims and defended a suit. In 1948, the company bought a dry dock and rented it. The taxpayer had no excess profits tax net income for 1946. It claimed a carry-back of unused excess profits credit to 1944. This was denied.

(B) For discussions under the 1954 Code, see Graichen, "The Net Operating Loss Deduction as Applied to Corporations," 33 Taxes 519 (1955); Winton, "Loss Corporations and Carry-overs," 34 Taxes 549 (1956); Brody, "Net Operating Loss Deduction," 34 Taxes 325 (1956).

The net operating loss deduction is an "averaging" device.[1] Under the 1954 Code, there is a period of eight years over which a loss *may* be effective, so that a taxpayer will not over that period pay tax except upon the net amount of his income for all of the years taken together—if his losses occur in the right years.

[1] The basic problem is discussed in Holt, "Averaging of Income for Tax Purposes: Equity and Fiscal Policy Considerations," 2 Nat.Tax J. 349 (1949); Butters, "Discriminatory Effects of the Annual Computation of the Corporate Income Tax," 54 Q.J.Econ. 51 (1939); Vickrey, "Averaging of Income for Income-Tax Purposes," 47 J.Pol.Econ. 379 (1939); Atlas, "Average Income and Its Use in Taxation," 13 Accounting Rev. 124 (1939); Preinreich, "Taxation and the Natural Business Year," 8 Accounting Rev. 317 (1933). See also Simon, Personal Income Taxation, 154 (1938).

Losses at the end of the eight year period can be carried back only two years, and if not so used, will not be effectively utilized unless the taxpayer has income within the five succeeding years.

Compare the former provision of the British law for computing the tax on the average income of three years.[2]

Deductions of Individuals

Sections 212–216 of the 1954 Code contain a number of additional deductions available to individuals. Of these, the deduction of expenses for the production of income (sec. 212) has been considered earlier in this chapter in connection with the business expense deduction. Similarly the deduction for interest and taxes in a cooperative housing corporation (sec. 216) has been considered above in connection with the deductions for interest and taxes. The deduction for child care expenses (sec. 214) has been mentioned above in connection with the consideration of personal expenses. Finally, the deduction for alimony (sec. 215) has been referred to in the "What is Income" Chapter, in connection with the consideration of the question whether the receipt of alimony is income.

This leaves for consideration here only one of the sections in this group in the 1954 Code.

Medical Expenses

Sec. 213 of the 1954 Code, and sec. 1.213–1 of the Income Tax Regulations

The medical expense deduction was introduced into the old Code in 1942, where it appeared in sec. 23(x). It was liberalized as to persons over 65 in 1951, and further liberalized in 1954. For general discussion, see Webster, "Medical Expense Deductions under Section 23(x)," 31 Taxes 7 (1953); Jensen, "Rationale of the Medical Expense Deduction," 7 Nat.Tax J. 274 (1954).

[2] The English law to this effect was changed by sec. 29 of the Finance Act, 1926, 16 & 17 Geo. V, c. 22. This was enacted as a result of the decisions in Brown v. National Provident Institution, [1921] 2 A.C. 222, and Whelan v. Henning, [1926] A.C. 293, which held that no tax could be assessed if no income had been received during the year of assessment, even though the two previous years had produced large income. By sec. 342 of the Income Tax Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, c. 10, it is provided that net losses "shall be carried forward, and, as far as may be, deducted from or set off against the amount of profits or gains . . . for the six following years of assessment." Under sec. 341 of the same Act, a loss of one year may in effect be applied against the income of the previous year.

REVENUE RULING 59–411

Internal Revenue Service, 1959. 1959–2 Cumulative Bulletin 100.

The Internal Revenue Service will follow the decision of the United States District Court for the Western District of Oklahoma in the case of *James E. Berry et ux. v. Earl R. Wiseman* (W.D.Okl.1958) 174 F.Supp. 748.

The court ruled that the cost of an elevator installed in the taxpayers' residence was deductible as a medical expense. The elevator had been installed at a cost of some $4,000 on the advice of a doctor to alleviate an acute coronary insufficiency of Mrs. Berry.

Accordingly, expenditures made for medical purposes will not be disallowed merely because they are of a capital nature. However, it is the position of the Service that the capital nature of an expenditure will be a consideration in determining its deductibility. If such expenditures constitute amounts paid out for permanent improvements which *increase the value* of any property or estate, they will not be allowed as medical expense deductions.

Steps will be taken to modify outstanding rulings contrary to this court decision and to conform Treasury regulations promulgated under section 213 of the Internal Revenue Code of 1954.

HEARD v. COMMISSIONER

United States Court of Appeals, Third Circuit, 1959. 269 F.2d 911.

MCLAUGHLIN, CIRCUIT JUDGE. Petitioners ask for review of a decision of the Tax Court, 30 T.C. 1093 (1958), which held that the premiums paid by taxpayer for old line health and accident policies are a medical deduction under § 23(x) of the 1939 Internal Revenue Code as amended 26 U.S.C. 1952 ed., only to the extent that they are applied to medical or hospitalization coverage. . . .

In 1953, § 23(x) controlled deductions for medical care. It made deductible from gross income "Expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent * * *." As to "medical care" it stated:

> "* * * The term 'medical care,' as used in this subsection, shall include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body *(including amounts paid for accident or health insurance)*. * * *" (Emphasis supplied.)

The words of the above statute are to be given their normal meaning without striving to read exceptions into them. Deputy v. Dupont, 1940, 308 U.S. 488, 493; Blaess v. Commissioner, 1951, 28 T.C. 710. Despite the incorporation of the phrase "* * * amounts paid for accident or health insurance" into the definition of "medical care", the Commissioner insists that the fair and natural meaning of § 23(x) is not what it says but that in some fashion it eliminates amounts paid for accident and health insurance to provide indemnity for loss of life, limb, sight and time from inclusion under the statutory definition of expenses paid for "medical care". It is asserted in respondent's brief that this statement is supported by the Senate Finance Committee Report (S.Rep. No. 1631, 77th Cong., 2nd Sess., pp. 95–96) accompanying the Revenue Act of 1942. The brief goes on to say:

"That Report states in part:

> "The term 'medical care' is broadly defined to include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. It is not intended, however, that a deduction should be allowed for any expense that is not incurred primarily for the prevention or alleviation of a physical or mental defect or illness."

The next following sentence of the report, which is not quoted in the brief, reads:

> "Although a deduction is denied with respect to such expenses as are compensated for by insurance or otherwise, *amounts paid for accident or health insurance are included in the category of medical expenses.*" (Emphasis supplied.)

The Senate Report by this statement unmistakably indicates that the direct language of the parenthetical clause of § 23(x), which includes amounts paid for accident or health insurance as proper deductions under medical care, is no inadvertence but the considered decision of the Senate Finance Committee which was adopted as proposed.

Whatever the Tax Court's current attitude may be towards the 1939 Code's specific designation of accident or health insurance premium payments to be deductible, in 1952 it held that the Commissioner had erred in disallowing as a deductible item, a health and accident premium payment. Concerning that payment it said, "It is clearly allowable as an item of *total* expenditure for medical expenses under Section 23(x), Internal Revenue Code." Taylor v. Commissioner, 1952, 11 T.C.M. 652, 655. (Emphasis supplied).

The 1954 Code continues § 23(x) as § 213. The continuance of the full deductibility of paid accident and health insurance premiums was patently no oversight. This is revealed forcibly by

the fact that when in §§ 104 and 105 of the 1954 Code, the Congress wished to break down accident and health coverage into its separate items it did so in so many words. In both sections exclusions are granted for accident and health items "* * * except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc. expenses) for any prior taxable year." [1]

Notes

(A) The Treasury has announced that it will not follow this decision. Rev.Rul. 59–393, 1959–2 Cum.Bull.

(B) The medical expense deduction has (for taxpayers under 65) a floor below it which is based on the "adjusted gross income" defined in sec. 62. Note the maximum limitations which are specified in sec. 213.

(C) Are amounts spent to maintain young children in boarding school deductible, when this was done to alleviate the condition of their mother and to help prevent the recurrence of an illness from which she was suffering? See *Ochs v. Commissioner*, 195 F.2d 692 (C.A.2d), cert. den. 344 U.S. 827 (1952).

Special Deductions for Corporations

Secs. 241–248 of the 1954 Code

There are a number of special deduction provisions applicable to corporations. Of these, the one relating to the deduction of organizational expenditures (sec. 248) has already been considered above in connection with the distinction between business expenses and capital expenditures.

Brief reference may be made to the following corporate deductions:

Partially tax exempt interest. The interest on some federal bonds is exempt from normal tax. This is accomplished, in the case of corporations, by allowing the deduction of such interest, under sec. 242 of the 1954 Code. Then this interest is added back to taxable income for the purpose of determining the surtax liability, under sec. 11(c).

For individuals, no deduction is allowed for partially tax exempt interest. But a credit of 3% of the interest against the tax, on account of the normal tax, is allowed to individuals by sec. 35.

Dividends received. Under sec. 243 corporations are allowed to deduct 85% of the dividends which they receive from domestic corporations. This is designed to prevent pro tanto the double or multiple taxation of corporate income, at least while it is still

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[1] A portion of the opinion, relating to other matters, is omitted.

held in corporate control. Sec. 245 allows a similar deduction in the case of dividends received from certain foreign corporations which have substantial income within the United States.

Dividends Paid on Preferred Stock of Public Utilities

Sec. 247, in complicated terms, allows a partial deduction for dividends paid on preferred stock of certain utilities. Sec. 244 makes a corresponding adjustment in the dividends received deduction, so that a double deduction will not be allowed when a corporation receives a dividend on a preferred stock of a public utility for which a deduction has been allowed to the paying corporation.

Items Not Deductible

Secs. 261–273 of the 1954 Code

Most of the items which are not deductible have already been dealt with in the earlier portions of this Chapter, since it is helpful to consider them in connection with the deduction provisions, in order to work out the line between the items which are deductible and those which are not deductible.

Special reference will be made here to two of these provisions.

Losses, Expenses, and Interest Between Related Taxpayers

Sec. 267 of the 1954 Code

The provision now found in sec. 267 of the 1954 Code goes back to sec. 24(b) and (c) of the 1939 Code. Why is it necessary? Cf. *Commissioner v. Auto Strop Safety Razor Co.*, 74 F.2d 226 (C.C.A.2d, 1934). In that case, a company had two subsidiaries. One owned patents, and licensed the other, for a royalty, to manufacture under the patents. The manufacturing company was on the accrual basis, and accrued and deducted the royalties. The patent company was on the cash basis. The royalties were not in fact paid, so the patent company had no income, though it built up a large account receivable. In due course, the parent company liquidated the patent company, thus acquiring the claim against the manufacturing company. There was no tax on this liquidation, since it was an intercorporate liquidation. Then the parent cancelled the debt owed by the manufacturing company as a contribution to the latter's capital. Thus the manufacturing company deducted a large amount for royalties without ever paying any at all!

Suppose an item covered by sec. 267(a)(2) is paid four months after the close of the taxable year. Is any deduction allowable at any time? See *P. G. Lake, Inc. v. Commissioner*, 148 F.2d 898 (C.C.A.5th, 1945), cert. den. 326 U.S. 732 (1945).

All three of the conditions specified in sec. 267(a)(2) must be met before an expense deduction will be disallowed. Thus if the item is includible in the payee's income because of "constructive receipt," sec. 267(a)(2)(A) does not apply, and the deduction is allowable. See *Glenwood Sanatorium*, 20 T.C. 1099 (1953).

See Gilliam, "Some Effects of Nonrecognized Losses on Corporations and Their Shareholders," 35 N.C.L.Rev. 31 (1956); Carroad and Handman, "The Nondeductibility of Certain Losses, Expenses and Interest Items," 33 Taxes 124 (1955); Gutkin and Beck, "Salary and Interest Disallowances under Section 24(c)," 81 J. of Accountancy 291 (1946); Roehner, "The Tax Court, The Treasury and Section 24(c)," 25 Taxes 637 (1947).

Further reference will be made to this provision in connection with the capital gain and loss chapter, below.

Acquisitions Made to Evade or Avoid Income Tax

Sec. 269 of the 1954 Code

Sec. 269 of the 1954 Code contains a sweeping provision disallowing deductions where a person or a corporation acquires a corporation or property for the purpose of securing a deduction, credit or other tax allowance. This provision should be considered along with sec. 382 which disallows the deduction for a net operating loss in certain cases where a loss corporation is acquired.[1] See pages 757–761, below.

CREDITS AGAINST THE TAX

The 1954 Code provides two new credits against the tax.

Dividends received by individuals. The first $50 of dividends received by any individual is excluded from his taxable income by sec. 116 of the 1954 Code. In addition to that, sec. 34 allows a limited credit against the tax in the amount of a percentage of the remaining dividends received by an individual. This is designed as a partial relief against double taxation in the case of corporate dividends.[2]

Query: How far is there in fact a double tax? Is the burden of the tax on the corporation borne by the shareholder or is that tax to some extent passed on to the employees or to the customers of the company?

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1 See Kirkpatrick, "Section 269 of the 1954 Code—Its Present and Prospective Function in the Commissioner's Arsenal," 15 Tax L.Rev. 137 (1960); Rice, "Internal Revenue Code, Section 269; Does the Left Hand Know What the Right Hand is Doing?" 103 U. of Pa.L.Rev. 579 (1955); Liles, "Section 269 of the 1954 Code: Acquisitions to Avoid Federal Income Tax," 41 A.B.A.J. 936 (1955).

2 See Shoup, "The Dividend Exclusion and Credit in the Revenue Code of 1954," 8 Nat.Tax J. 136 (1955); Harris, "The Individual Dividends Received Credit and Capital Gains," 34 Taxes 536 (1956).

Retirement income. There is also a rather complicated and restricted credit for retirement income, provided by sec. 37 of the 1954 Code.

This provision was amended by the Act of January 28, 1956, so that individuals over 65 can earn $1,200 instead of $900, without reducing the retirement income credit.

The retirement income credit is not applicable to royalties on books. Rev.Rul. 55–636, 1955–2 Cum.Bull. 17.

CHAPTER 7

WHEN IS IT INCOME?—OR DEDUCTIBLE?—ACCOUNTING PROBLEMS

"I regard it as an inescapable fact, which must be taken into account in the formulation of any income concept, that the allocation of income to short periods of time is necessarily conventional and must be based on assumptions which are known not to be completely valid." May, Business Income and Price Levels vi (1949).

Secs. 441–482 of the 1954 Code[1]

Regulations have been issued under a number of the sections relating to accounting problems, and can be found by reference to the corresponding section numbers in the Income Tax Regulations.

The basic statutory provisions on accounting matters are found in secs. 441 to 482 of the 1954 Code, which should be carefully examined. They are far from perfect, though they are now much more developed than they were before 1954. Indeed the knowledge of the problems by lawyers was so lacking that the early income tax statutes had no accounting provisions at all. The first sections were inserted by the Revenue Act of 1918, and were not developed materially after that until 1954. Other sections have been added, however, dealing with specific problems, such as secs. 453, 691, and 1301 to 1315 of the 1954 Code.

It is usually a shock to law students to find that two persons may carry out precisely the same transactions, and yet have wholly different incomes and tax liabilities, depending only on the rather formal fact of how they keep their books. As a practical matter, income taxes must be collected on a periodic basis. It is obviously not reasonable to wait until a man's death, then cast up accounts for his entire lifetime, and collect an income tax on the net result.[2] The period normally selected has been an an-

[1] See Austin, Surrey, Warren and Winokur, "Tax Accounting," 68 Harv.L. Rev. 257 (1954); "Clearly Reflecting Income under § 446 of the Internal Revenue Code," 54 Col.L.Rev. 1267 (1954).

[2] But cf. Vickrey, "Averaging of Income for Income-Tax Purposes," 47 J. Pol.Econ. 379, 390 (1939). See also Bravman, "Equalization of Tax on All Individuals with the Same Aggregate Income over Same Number of Years," 50 Col.L.Rev. 1 (1950); Vickrey, "Effect of Averaging on the Cyclical Sensitivity of the Yield of the Income Tax," 53 J. of Pol.Econ. 275 (1945); Kragen and Adler, "Taxation of Individuals with Fluctuating Incomes," 48 Calif.L. Rev. 31 (1960).

nual one, and the problems which will not be considered arise because of the necessity of assigning particular elements of income or deductions to one period or another.[3]

THE TAXABLE YEAR

BURNET v. SANFORD & BROOKS CO.

Supreme Court of the United States, 1931. 282 U.S. 359.

MR. JUSTICE STONE delivered the opinion of the Court.

In this case certiorari was granted to review a judgment of the Court of Appeals for the Fourth Circuit, 35 F.2d 312, reversing an order of the Board of Tax Appeals, 11 B.T.A. 452, which had sustained the action of the Commissioner of Internal Revenue in making a deficiency assessment against respondent for income and profits taxes for the year 1920.

From 1913 to 1916, inclusive, respondent, a Delaware corporation engaged in business for profit, was acting for the Atlantic Dredging Company in carrying out a contract for dredging the Delaware River, entered into by that company with the United States. In making its income tax returns for the years 1913 to 1916, respondent added to gross income for each year the payments made under the contract that year, and deducted its expenses paid that year in performing the contract. The total expenses exceeded the payments received by $176,271.88. The tax returns for 1913, 1915, and 1916 showed net losses. That for 1914 showed net income.

In 1915 work under the contract was abandoned, and in 1916 suit was brought in the Court of Claims to recover for a breach of warranty of the character of the material to be dredged. Judgment for the claimant, 53 Ct.Cl. 490, was affirmed by this Court in 1920. *United States v. Atlantic Dredging Co.*, 253 U.S. 1. It held that the recovery was upon the contract and was "compensatory of the cost of the work, of which the government got the benefit." From the total recovery, petitioner received in that year the sum of $192,577.59, which included the $176,271.88 by which its expenses under the contract had exceeded receipts from it, and accrued interest amounting to $16,305.71. Respondent having failed to include these amounts as gross income in its tax returns for 1920, the Commissioner made the deficiency assessment here involved, based on the addition of both items to gross income for that year.

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3 See May, "Accounting and the Accountant in the Administration of Income Taxation," 47 Col.L.Rev. 377 (1947); Margulies, "Accounting Methods for Income Tax Purposes," 25 Taxes 816 (1947). For general reading in the field, see May, Financial Accounting (1943).

The Court of Appeals ruled that only the item of interest was properly included, holding, erroneously as the government contends, that the item of $176,271.88 was a return of losses suffered by respondent in earlier years and hence was wrongly assessed as income. Notwithstanding this conclusion, its judgment of reversal and the consequent elimination of this item from gross income for 1920 were made contingent upon the filing by respondent of amended returns for the years 1913 to 1916, from which were to be omitted the deductions of the related items of expenses paid in those years. Respondent insists that as the Sixteenth Amendment and the Revenue Act of 1918, which was in force in 1920, plainly contemplate a tax only on net income or profits, any application of the statute which operates to impose a tax with respect to the present transaction, from which respondent received no profit, cannot be upheld.

If respondent's contention that only gain or profit may be taxed under the Sixteenth Amendment be accepted without qualification, see *Eisner v. Macomber,* 252 U.S. 189; *Doyle v. Mitchell Brothers Co.,* 247 U.S. 179, the question remains whether the gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as is pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.

All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt. Under sections 230, 232 and 234(a) of the Revenue Act of 1918, 40 Stat. 1057, respondent was subject to tax upon its annual net income, arrived at by deducting from gross income for each taxable year all the ordinary and necessary expenses paid during that year in carrying on any trade or business, interest and taxes paid, and losses sustained, during the year. By sections 233(a) and 213(a) gross income "includes . . . income derived from . . . business . . . or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." The amount of all such items is required to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis under Section 212(b). See *United States v. Anderson,* 269 U.S. 422; *Aluminum Castings Co. v. Routzahn,* 282 U.S. 92.

That the recovery made by respondent in 1920 was gross income for that year within the meaning of these sections can-

not, we think, be doubted. The money received was derived from operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made a contract entered into in the course of respondent's business in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. See *Doyle v. Mitchell Brothers Co., supra,* p. 185.

That such receipts from the conduct of a business enterprise are to be included in the taxpayer's return as a part of gross income, regardless of whether the particular transaction results in net profit, sufficiently appears from the quoted words of Section 213 (a) and from the character of the deductions allowed. Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.

Bowers v. Kerbaugh-Empire Co., 271 U.S. 170, on which respondent relies, does not support its position. In that case the taxpayer, which had lost, in business, borrowed money, which was to be repaid in German marks, and which was later repaid in depreciated currency, had neither made a profit on the transaction, nor received any money or property which could have been made subject to the tax.

But respondent insists that if the sum which it recovered is the income defined by the statute, still it is not income, taxation of which without apportionment is permitted by the Sixteenth Amendment, since the particular transaction from which it was derived did not result in any net gain or profit. But we do not think the amendment is to be so narrowly construed. A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any sys-

tem of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis. The computation of income annually as the net result of all transactions within the year was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment. See *Bowers v. Kerbaugh-Empire Co., supra*, p. 174; *Pacific Insurance Co. v. Soule,* 7 Wall. 433; *Pollock v. Farmers' Loan & Trust Co.,* 158 U.S. 601, 630. It is not to be supposed that the amendment did not contemplate that Congress might make income so ascertained the basis of a scheme of taxation such as had been in actual operation within the United States before its adoption. While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. If losses from particular transactions were to be set off against gains in others, there would still be the practical necessity of computing the tax on the basis of annual or other fixed taxable periods, which might result in the taxpayer being required to pay a tax on income in one period exceeded by net losses in another. . . .

The assessment was properly made under the statutes. Relief from their alleged burdensome operation which may not be secured under these provisions, can be afforded only by legislation, not by the courts.

Reversed.

Note

The basic statutory provision on the taxable year is sec. 441 of the 1954 Code. (Note that secs. 1, 3 and 11 impose the tax "for each taxable year.") Ordinarily the taxable year is a relatively simple concept. For most individuals and a great many businesses, it is simply the calendar year—from January 1st through December 31st. However, individuals and businesses may use a fiscal year, which must end on the last day of the month, but this month can be any month other than December. The 1954 Code introduces a new fiscal year for taxpayers keeping their books on the basis of a year of 52 or 53 weeks. Finally, there can be short taxable years. See sec. 443. But these are not frequently met.

We have already encountered provisions designed to mitigate the effect of the annual computation of tax, such as the net operating loss deduction, which operates, in some cases, to spread a loss sustained in one taxable year over a number of other taxa-

ble years. There are other such provisions, such as the capital loss carry-over, options to deduct or capitalize, the "tax benefit" concept, and so on. But the concept of the taxable year remains fundamental. Tax computations are basically made with respect to taxable years. If there is any amelioration of the effect of the taxable year it is due to specific statutory provisions designed for that purpose.

For consideration of problems in one special field, see Frank, "Estate Planning: The Taxable Year," 34 Taxes 202 (1956).

REVENUE RULING 54–273

Internal Revenue Service, 1954. 1954–2 Cum.Bull. 110.

Advice is requested whether a taxpayer who begins a business on a date other than the first day of a calendar month and adopts an accounting period of exactly 12 months from the date business was begun has established an annual accounting period within the meaning of section 41 of the Internal Revenue Code. Advice is also requested whether such taxpayer is required to obtain the approval of the Internal Revenue Service to change his accounting period from such 12-month period to a calendar year.

Section 41 of the Internal Revenue Code, relating to accounting periods and methods of accounting reads as follows:

> General Rule. The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

Section 48(b) of the Internal Revenue Code defines a fiscal year as follows:

> Fiscal Year.—"Fiscal Year" means an accounting period of twelve months ending on the last day of any month other than December.

Under the circumstances here stated, the taxpayer has failed to establish an accounting period which may be recognized under the Internal Revenue Code. Under the provisions of section 41 of the Code, the taxpayer is required to make his return on the basis of a calendar year. Accordingly, the approval of the Com-

missioner is not required to enable the taxpayer to compute his net income on the basis of a calendar year.

Since such taxpayer has failed to establish a fiscal year within the meaning of the law, any return filed on the incorrect basis of exactly 12 months from the date business was begun should have been filed on the basis of a calendar year. *Park-Chambers, Inc. v. Commissioner,* 46 B.T.A. 144, affirmed 131 F.2d 65. The matter of filing corrected returns should be taken up with the District Director of Internal Revenue for the district in which such returns were filed.

Change of Accounting Period

Changes from one accounting period to another are governed by secs. 442 and 443 of the 1954 Code. *Cf. Helvering v. Morgan's Inc.,* 293 U.S. 121 (1934); *Waterman Steamship Corp. v. United States,* 91 Ct.Cl. 249, 32 F.Supp. 880 (1940). See Holzman, "Calendar v. Fiscal Year," 20 Taxes 211 (1940); Edelson, "Changing Accounting Periods," 23 Taxes 408 (1945).

Methods of Accounting

The statutory provisions on methods of accounting are somewhat rudimentary, although slightly more extensive in the 1954 Code than they were previously. The general rule is prescribed in sec. 446. Under this there are two basic methods—the cash method, and accrual methods. In addition there are certain special methods for particular types of transactions, such as installment sales, which are covered by sec. 453 of the 1954 Code.

General provisions as to the taxable year in which items of gross income are to be included, and items of deduction are to be taken, are given in secs. 451 and 461 of the 1954 Code.

For the most part, the cash basis has the great virtue of simplicity. The accrual basis gives a more accurate reflection of income in terms of economic gain. Almost all individuals use the cash basis. Almost all business enterprises use some form of accrual basis.

We will consider first some questions arising primarily under the cash basis.

CASH BASIS

On the cash basis items of income are ordinarily included in the year in which they are "received," and items of deduction are taken in the year in which they are "paid." [1] For the most part the answers are clear and simple. There is not usually much doubt about the time for inclusion or deduction on a cash basis return, even though a cash basis taxpayer may in some circumstances accelerate or postpone the receipt of income (for example, by sending out bills, or refraining from doing so); and he may materially affect his deductions by making a number of deductible expenditures before the close of the taxable year or deferring them until the following year.

SCHLEMMER v. UNITED STATES

United States Circuit Court of Appeals, Second Circuit, 1938. 94 F.2d 77.

L. HAND, CIRCUIT JUDGE. The judgment on appeal dismissed a petition under the Tucker Act, 24 Stat. 505, to recover part of the plaintiff's income tax, paid for the year 1927. He was president of a company engaged in the contracting business, one, Richardson, was vice-president, and the two with their wives owned all the shares. In the spring of 1927 as directors they had voted themselves each a salary of $30,000, which the company was not in a position to pay at the end of that year. At some time which is in dispute they signed and delivered two notes for $30,000, payable to each respectively, dated December 31, 1927; and we will assume that this was the date of execution. These were never paid; during the year 1929, $3,000 was paid on the plaintiff's, but that was all. Both the plaintiff and the company returned their taxes on a cash basis; yet the company deducted both notes from its income, and the plaintiff charged himself with his, and paid the tax so computed. Later he filed a claim for refund; based, first, upon the assertion that he had not received the note during 1927; and second, upon the point of law that even though he had it was not part of his income for that year. The claim was refused, and the judge found for the defendant on both points.

The plaintiff's note did not pay the company's debt, unless the parties agreed that it should. *Peter v. Beverly,* 10 Pet. 532, 568; *Lyman v. Bank of United States,* 12 How. 225, 243; *The Emily Souder,* 17 Wall. 666, 670; *Segrist v. Crabtree,* 131 U.S. 287. The defendant asserts that they had so agreed because of the tax returns; but that is not so. Those did indeed presuppose that the

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[1] For general consideration of cash basis accounting, see "Time When Items Become Income to the Cash Basis Taxpayer," 53 Harv.L.Rev. 851 (1940); Bowe, "Cash and Accrual Methods of Income Tax Accounting," 3 Vanderbilt L.Rev. 60 (1949).

note was a proper entry in a cash return, but that does not show that the parties had agreed that it should be payment; they may have supposed that a note so taken always pays the debt; or that it must be treated as cash whether it was payment or not. They were laymen, and we can tell nothing about what facts they took for true in reaching the conclusion that the note was cash. The only actual testimony was that the note was not taken as payment, but only as more permanent evidence of the debt. Indeed, it is not at all clear that it would have been a cash item, even if it had in fact been taken as payment. It did not change the substance of the debt—not being endorsed or secured—and although it was more readily disposable, that single incident was scarcely enough. There must be more than difference in the mere form of property to justify a charge of income. *Weiss v. Stearn,* 265 U.S. 242. But we need not stand on that; in any case since it was not taken as payment, it could not be treated as cash; the old debt remained, the note was no more than added security. *Sass v. Commissioner,* 12 B.T.A. 156 (semble); *Merren v. Commissioner,* 18 B.T.A. 156; *Humphrey v. Commissioner,* 32 B.T.A. 280. . . .

Judgment reversed; judgment to be entered for the plaintiff.[1]

Notes

(A) In *Jay A. Williams,* 28 T.C. 1000 (1957), the taxpayer received a note at a time when its maker was without funds; he tried to sell it without success. It was held that this was not the equivalent of cash, and not income when received. The Commissioner has published his acquiescence in this decision. 1958–1 Cum.Bull. 6.

(B) *Constructive Receipt.* Even on the cash basis, there are circumstances when an item may be income, although it has not actually been "received." This is known as "constructive receipt." See 1.451–2 of the Income Tax Regulations. Roughly speaking, it may be said that an item has been "constructively received" when it has been unqualifiedly made subject to the taxpayer's demand. Examples are salary credited to an employee, though not withdrawn (*Schoenheit v. Lucas,* 44 F.2d 476 (C.C.A. 4th, 1930)); interest credited on savings bank deposits (*Edward Mallinckrodt, Jr.,* 38 B.T.A. 960 (1938); *Alexander Zolotoff,* 41 B.T.A. 991 (1940)); and matured bond coupons, even though the taxpayer is absent and unable to cut the coupons (*Loose v. United States,* 74 F.2d 147 (C.C.A.8th, 1934)). See Zysman, "Constructive Receipt of Income," 16 Tax Mag. 715 (1938); "Constructive Receipt: When Must the Taxpayer Pay?" 45 Ill.L.Rev. 77 (1950).

(C) In *Hedrick v. Commissioner,* 154 F.2d 90 (C.C.A.2d, 1946), a corporate officer retired, but refused to sign the usual

[1] See comment in 51 Harv.L.Rev. 1115 (1938); Frank, "Promises to Pay in the Future as Present Income to the Cash Basis Taxpayer," 4 Intramural L.Rev. 274 (1949).

pension application form because he feared that a pension might make it more difficult for him to obtain employment elsewhere. Nevertheless, the company sent him checks. He neither returned them nor cashed them. The court held that he constructively received the income, and was taxable on it.

(D) The taxpayer was trustee of a trust by the terms of which he was entitled to take three per cent of the income as compensation for his services. In fact he took nothing. Is he taxable on the amount which he might have taken, if he chose (with perhaps a gift tax, too, on the amount thus given to the beneficiaries)? *Commissioner v. Mott,* 85 F.2d 315 (C.C.A.6th, 1936), noted in 23 Va.L.Rev. 219 (1936). Suppose he draws a check to his own order for the commissions but does not cash it. See *Anderson v. Bowers,* 170 F.2d 676 (C.A.4th, 1948), cert. denied 337 U.S. 918 (1949). Cf. *Pletz v. Commissioner,* 43 B.T.A. 140 (1940), where the trustee took his commissions, but all at the termination of the trust when his account was settled. He could have taken them from time to time during the administration of the trust. He contended unsuccessfully that they were taxable in the earlier periods when he could have taken them.

LAVERY v. COMMISSIONER

United States Circuit Court of Appeals, Seventh Circuit, 1946. 158 F.2d 859.

EVANS, CIRCUIT JUDGE. This appeal involves a dispute over the year a sum received by Lavery, the taxpayer, appellant herein, was taxable under the federal income tax law.

Mr. Lavery, the taxpayer, had been managing editor of the American Bar Association Journal. He was paid in full for his 1941 services. He terminated his services and the Board of Editors tendered him an honorarium, a check for $2,666.67, which he accepted as "payment in full satisfaction of all his claims against the said Association and the members of the said Board of Editors on account of his said employment as such Managing Editor and the termination of that position." The check represented four months' pay at the rate of $8,000 per annum.

The check was received December 30, 1941, and cashed January 2, 1942. December 30th fell on Tuesday.

Taxpayer reported on the cash receipts and disbursements basis.

The applicable statute provides

Section 22(a) " 'Gross income' includes . . . income derived from salaries, wages, or compensation for personal services . . . of whatever kind and in whatever form paid . . ."

The Regulation (103, Sec. 19.41–2) contains the following:

"All items of gross income shall be included in the gross income for the taxable year in which they are *received* by the tax-

payer. . . . A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction.

"Income which is credited to . . . or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition."

Taxpayer relies upon the case of *Avery v. Commissioner,* 292 U.S. 210. In the later case of *Putnam v. Commissioner,* 324 U.S. 393, the Court referred to its holding in the Avery case as follows: "*Avery v. Commissioner* . . . holds that dividends of a living taxpayer on the cash basis would not become his income on mere declaration but only when 'received,' that is, unqualifiedly made subject to the stockholder's demand *as by check.* . . ." (Italics ours.)

The Court inferentially holds that receipt of a check is equivalent to the receipt of cash. The *Avery* case was decided on the fact hypothesis that the check was not received until January, following its execution in December.

There might perhaps be a distinction between the date of receipt of cash and the date of the receipt of a check which arrived the last day of the year and too late to be cashed by the payee on that day. In the instant case the taxpayer could have cashed the check on the day it was received by him, or at least on the next day. There was no doubt about the validity of the check or the solvency of the drawer.

Our conclusion is that the check was the equivalent of cash in this case, and this being so, we must hold it was received in 1941. Magill, Taxable Income, Rev.Ed., 1945, p. 179; *Hedrick v. Commissioner,* 2 Cir., 154 F.2d 90, 91.

Taxpayer also argues that the check was in payment of services by him rendered in 1942. While the fact assertion on which this argument is predicated is disputed, we dispose of this appeal on the theory that the date of the payment, not the date of the rendition of the services, is the determinative fact.

The decision of the Tax Court is affirmed.

Notes

(A) In *Charles F. Kahler,* 18 T.C. 31 (1952), the taxpayer received a check on December 31st, after five p. m., and after banking hours. He presented it to the bank on the following January 2nd, and it was paid. The full Tax Court held that it was income in December, when received by the taxpayer.

(B) A corporation declared a dividend payable on December 31, and checks were mailed to the stockholders on that day. The petitioner received his on January 2; his accounts were kept on the cash basis. The Court held that the petitioner was taxable in the year in which the check was received, saying: "In the disclosed circumstances the dividends cannot properly be considered as cash or other property unqualifiedly subject to the petitioner's demand on December 31st. . . . The checks did not constitute payments prior to their actual receipt." *Avery v. Commissioner,* 292 U.S. 210, 215 (1934). This is true even though the check could have been picked up on December 31, by special arrangement, but was not. *Commissioner v. Fox,* 218 F.2d 347 (C.A.3d, 1954).

(C) A corporation declared dividends payable on December 31, 1940, to stockholders of record on November 27, 1940. Shares were held by an estate of which A was life beneficiary. On December 30, 1940, A assigned his entire interest to a charity. The dividend was received by the executor on December 31, 1940, and distributed to the charity on the same day. The Treasury ruled that the dividend was taxable to A, the assignor. I.T. 4007, 1950–1 Cum.Bull. 11. *Cf. Helvering v. Horst,* set out at p. 230 above.

(D) A man drew and delivered checks for charitable contributions on December 30 and 31. They were paid by his bank on January 4 and 11, respectively. The drawer of the checks died on January 8. The Tax Court held that both items were deductible as charitable contributions paid in December. *Estate of Spiegel,* 12 T.C. 524 (1949). The Commissioner has acquiesced in this decision. 1949–2 Cum.Bull. 3. The *Spiegel* case was followed in *Estelle Broussard,* 16 T.C. 23 (1951). See also Rev.Rul. 54–465, 1954–2 Cum.Bull. 93.

Compare *Estate of Hubbell,* 10 T.C. 1207 (1948), where a man mailed a check for state taxes on July 10, 1944. The check was received in due course and the bank had sufficient funds. The man died on July 20, 1944. The check was not presented to his bank until after that date, and the bank refused payment because of his death. His executor thereupon issued a new check for the taxes. The executor endeavored to deduct the taxes for the period prior to the decedent's death, but the Tax Court held that the state tax was not "paid" before the decedent's death.

(E) On December 31, 1942, the taxpayer received a check in payment of legal services. At the time of delivery, the drawer stated that he was short of money and would appreciate it if the taxpayer would hold the check for a few days; and the taxpayer agreed to do so. It was held that the check was not income in 1942. *L. M. Fischer,* 14 T.C. 792 (1950). Similarly, where salary checks were delivered, but it was understood that they would

not be presented by any of the recipients until there were funds available sufficient to pay the entire group which received such checks, it was held that there was no income at the time of the receipts of the checks. *George W. Johnson,* 25 T.C. 499 (1955).

(F) A dividend was declared, payable in 1946. It was not paid to one stockholder, A, until 1947, at his request. It was held that the dividend was constructively received by A in 1946, and income to him in that year. *Frank W. Kunze,* 19 T.C. 29 (1952).

(G) See, generally, "Checks and Notes as Income When Received by a Cash-Basis Taxpayer," 73 Harv.L.Rev. 1199 (1960).

ANTHONY P. MILLER, INC. v. COMMISSIONER

United States Circuit Court of Appeals, Third Circuit, 1947. 164 F.2d 268.

GOODRICH, CIRCUIT JUDGE. In asking reversal of a decision by the Tax Court the taxpayer corporation tenders us six issues. Five of them present questions of fact; one presents a question of law. The question of law will be treated first.

The question of law is narrow but interesting. It has to do with Section 24(c) of the Internal Revenue Code, 26 U.S.C.A.Int. Rev.Code, § 24(c), dealing with situations in which deductions are not allowed under certain circumstances. The Section precludes a deduction if the three conditions set out in it are all met.[1] There is no dispute that two of the provisions are met in this instance. Our question turns upon the third which is whether the taxpayer corporation "paid" its obligation for salary for the year 1940 to its President, Anthony Miller, within two and one half months after the end of the taxable year 1940.

On January 1, 1941 the corporation gave negotiable promissory notes, payable on demand, to President Miller. The amount payable, upon these notes, represented the salary which the corporation owed Miller for services during the preceding year, plus other items not here important. The taxpayer corporation was, at the time of delivering the notes and at all other times here relevant, solvent and able to pay its obligations. The notes were, in fact, paid on December 31, 1942.

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1 "Sec. 24. Items Not Deductible.

(c) Unpaid expenses and interest.—In computing net income no deduction shall be allowed under section 23(a), relating to expenses incurred, or under section 23(b), relating to interest accrued—

(1) If such expenses or interest are not paid within the taxable year or within two and one half months after the close thereof; and

(2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and

(3) If, at the close of the taxable year of the taxpayer or at any time within two and one half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24(b)."

The question is whether, by giving these notes to Miller, the taxpayer "paid" its President's salary within the meaning of Section 24(c) (1) of the Internal Revenue Code. The Commissioner said it did not. The Tax Court, after full consideration, agreed with the Commissioner and rejected albeit respectfully, a conclusion of the Sixth Circuit to the contrary.[2] For the Commissioner it is argued that the words of the statute should receive their ordinary meaning unless circumstances show that something else was intended. Under that meaning, it is argued, "paid" means the giving of cash or its equivalent to the payee. Furthermore, the argument runs, the giving of a negotiable instrument leaves things between the parties without essential change from what they were before the instrument was given. The debtor still owes the money and the creditor has not received it. Thus the Commissioner concludes that the creditor in this case was not "paid" until the corporation discharged the notes by payment and that event, it is admitted, did not take place until 1942.

The point is one which can be argued either way and have the arguments make sense. We think, however, that the better argument is in favor of the view taken by the Sixth Circuit and against that taken by the Tax Court. When a debtor gives a creditor a negotiable instrument for a debt, legal relations between them are not the same as before by any means. The legal rule is well recognized that the giving and acceptance of the negotiable instrument is conditional payment of the debt and the creditor cannot proceed against the debtor on the original obligation until the instrument is either surrendered or dishonored.[3] If the parties agree, the acceptance of the negotiable paper will discharge the original debt altogether.[4]

In either event, the creditor with the negotiable instrument in his hands is in a much better position than a creditor without one. He has a piece of paper which he can transfer to a holder in due course free of equities. He has an instrument on which he makes out a case against the debtor simply by its presentation and proof of execution. The burden shifts to a defendant to show lack of consideration or other defense. All this is well

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2 Musselman Hub-Brake Co. v. Commissioner, 6 Cir., 1943, 139 F.2d 65. The Fifth Circuit has a decision relevant to the question, but the case is distinguishable from the facts here as it is admitted by the Government and was urged by the Solicitor General when certiorari was sought by an unsuccessful taxpayer following the decision in the Fifth Circuit. See P. G. Lake, Inc., v. Commissioner of Internal Revenue, 5 Cir., 1945, 148 F.2d 898, certiorari denied, 1945, 326 U.S. 732.

3 Cf. Knapp v. Gray, 1922, 153 Ark. 160, 239 S.W. 757; Carney v. Mortgage Security Corporation of America, 1929, 107 W.Va. 605, 149 S.E. 837.

4 Gaunt v. Alabama Bound Oil & Gas Co., 8 Cir., 1922, 281 F. 653, 23 A.L.R. 1279; Stebbins v. North Adams Trust Co., 1922, 243 Mass. 69, 136 N.E. 880; Brady v. Interstate Mortgage Co., 1924, 96 Okl. 293, 223 P. 145; Woods Bros. Corporation v. Francke, 1932, 122 Neb. 672, 241 N.W. 88.

known negotiable instruments law and we need not labor the point nor build up an appearance of erudition in this opinion with encyclopedic citations upon points which no one disputes.

Furthermore, as a matter of common parlance we think it is most common to speak of "paying" an obligation by giving one's check for it. That is the common method of paying bills in this country. The use of the demand negotiable note is not so frequent, but the two instruments have much in common nevertheless. Each is payable at once. Each rests on the credit of the maker or drawer, respectively, for the bank is under no obligation to the holder to pay a check. Nor is the drawing of the check an assignment of the debtor's account with the bank.

We think, therefore, that the taxpayer corporation paid its president's salary when, on January 1, 1941, it gave him negotiable demand promissory notes for the amount. Nor does this conclusion violate the spirit of the Act as found in its legislative history. Our brethren in the Sixth Circuit decision, already referred to, discussed this point in some detail and reference is made to the opinion in that case for its consideration. . . .

Our decision is, then, that the Tax Court is reversed so far as it concerns the deduction to the taxpayer for the salary. That salary is to be allowed as a deduction but only as to the $25,000 which the Tax Court found was the reasonable amount. On all other points the decision of the Tax Court is affirmed.

Notes

(A) See also *Slaymaker Lock Co. v. Commissioner,* 208 F.2d 313 (C.A.3d, 1953); Lourie and Cutler, "Payment under the Federal Tax Laws," 32 Taxes 7 (1954).

The result of the *Anthony P. Miller* case has now been accepted by the Treasury, and it has formally withdrawn its prior non-acquiescence on this point. Rev.Rul. 55–608, 1955–2 Cum. Bull. 546.

(B) In *H. & H. Drilling Co.,* 15 T.C. 961 (1950), a check was issued for salary to an officer who owned more than 50% of the company's stock. He endorsed it and deposited it in the company's bank account. The company did not otherwise have funds available to cover the check. The officer was credited on the company's books as having made an advance to it. It was held that the amount was not "paid" and that the company could not deduct it.

(C) In *J. D. O'Connor,* Memo.T.C., June 30, 1954, T on March 13, 1946, paid to his brother a bonus which had accrued in 1945, and which T sought to deduct for that year. T was short of working capital, as his brother knew; and on March 16, 1946, the brother loaned an identical amount to T. May T deduct the amount he paid? Suppose he had first borrowed the money from the brother and then paid it to him—perhaps all on the same day. Would this affect T's deduction?

ACER REALTY CO. v. COMMISSIONER

United States Circuit Court of Appeals, Eighth Circuit, 1942. 132 F.2d 512.

THOMAS, CIRCUIT JUDGE. . . .[1] The second element of the controversy is whether petitioner was in constructive receipt of rent from its tenant, the Sanatorium Company, for the year 1938 in the amount of $8,700. Petitioner carries its accounts on a cash basis and contends that it did not so receive such rentals.

The evidence tends to show that the agreed rental for the year 1938 was $18,000 subject to an increase in some amount on condition that the new buildings under construction at the beginning of the year should be completed and ready for occupancy before the end of the year. While the building program was under way the tenant had advanced to the petitioner on account sums totaling $10,500 and had paid on the 1938 rentals the sum of $9,300, leaving an unpaid balance, likewise carried on account, of $8,700. It was "the purpose", so petitioner's vice-president testified, "not to make an offsetting entry until it was determined whether the buildings would be ready." Sometime prior to the end of the year it was known that the buildings would not be ready for occupancy at any time during the year, and consequently that the rental would not be increased. The secretary-treasurer of the petitioner at the time of the hearing, who was also its attorney during the taxable period, testified: "I claim we could offset it, but we don't have to. * * * There was no reason why Acer could not credit $8,700 on the amount they owed Glenwood and there was no reason why they should."

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The Board found that "the intention of the parties was that these mutual debts were to be treated as parts of one transaction. The offset of one debt against the other was intended and petitioner had an absolute right to make it during the tax year. *Cf. Bailey v. Commissioner*, 103 F.2d 448." We think that the requirements of constructive receipt are satisfied and the petitioner could not, by merely delaying the making of a book entry, postpone this rent receipt to a future period.

The evidence supports the Board's finding that the intention and purpose of the parties were to set off these mutual debts; to make an offsetting entry in their books when but not until it was determined whether the buildings would be ready for occupancy during the year 1938; that before the end of the year the fact that the buildings would not be ready was determinable; and that petitioner had the right to make the set-off entry within the taxable year. The consent of the tenant inhered

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[1] A portion of the opinion, dealing with another question, is omitted.

in the agreement. The question for decision, therefore, is whether the petitioner for tax purposes had the right to delay the entry and postpone the "rent receipt to a future tax period."

It is true, as contended by the petitioner, that "Mutual debts do not per se extinguish each other." *Bailey v. Commissioner of Internal Revenue*, 5 Cir., 103 F.2d 448, 449. It is also the law that "Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him." *Helvering v. Horst,* 311 U.S. 112, 115. These rules are not inconsistent with the present decision. The principle here applicable is "that the power to dispose of income is the equivalent of ownership of it." *Harrison v. Schaffner*, 312 U.S. 579, 580. The revenue acts are "not so much concerned with the refinements of title as * * * with actual command over the property [which is] taxed—the actual benefit for which the tax is paid." *Corliss v. Bowers,* 281 U.S. 376, 378; *Harrison v. Schaffner, supra,* 312 U.S. at page 581. The last act necessary to give petitioner command over the $8,700 of rentals for 1938 was not the book entry but the failure to complete the buildings for occupancy in that year. The right of command existed upon the occurrence of that event and any delay in making the proper book entry could not change it. Upon petitioner's theory, if the set-off entry should never be made the tax would never accrue. *Riley Inv. Co. v. Commissioner,* 311 U.S. 55, 59. Negligent or willful delay in making a proper book entry cannot be used to defeat the taxing power. "* * * the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income can [not] escape taxation because he has not himself received payment of it from his obligor." *Helvering v. Horst, supra,* 311 U.S. at page 116. The taxpayer in the instant case enjoyed the benefit of the economic gain when the right to receive credit for the rent accrued. . . .

The decision of the Board of Tax Appeals is affirmed.

COMMISSIONER v. OATES

United States Court of Appeals, Seventh Circuit, 1953. 207 F.2d 711.

LINDLEY, CIRCUIT JUDGE. The Commissioner of Internal Revenue seeks to reverse the decision of the Tax Court reported in 18 T.C. 570. In view of the fact that the findings of the trial court are full and complete and are, as we believe, fully sustained by the evidence, we shall try to avoid needless reiteration.

As appears more fully in the reported decision, the amount of the compensation of a general agent of the Northwestern Life In-

surance Company, such as the taxpayer, depends not only on the amount paid as initial premium on a policy but also, in a lesser degree, upon the renewal premiums collected thereon during the next succeeding nine years. The original agency contract with the company provided that upon retirement, a general agent would receive commissions on renewal premiums as they were collected by the company during the nine-year period following the date of his retirement. Under the provisions of the contract as it then read, a retiring agent received a comparatively large amount as commissions during the first year. This sum decreased to less and less each year thereafter until, at the end of the ninth year, he received no further payments. Thus his income from renewal commissions progressively decreased as he grew older. The agents having become discontented with this unfortunate result, negotiations between them and the company were entered into in 1943 looking to a revision of the contract, culminating in March 1944, in an amendment which provided in short that commissions accruing after retirement of the agent would be paid in fixed monthly installments, irrespective of the time when the company collected them. The installments were to be paid over a period of not more than 180 months, but the agent might elect to receive them in fewer months, and was also given the option of remaining under the old contract or of accepting the new one.

This taxpayer, on April 27, 1944, accepted the amendment and elected to be bound by the Evans' Table C and to receive a monthly payment of $1000. He retired April 30, 1944. At that time there was no amount due or owing him from the company and no credit to him on the latter's books. The company began in June, 1944, to make payments to him of $1000 per month, continuing them through the years 1945 and 1946. The taxpayer included in his several income tax returns for those years the exact amounts he received.

As the accruing commissions came in, Northwestern entered them to the credit of the agent on its books but made payment not of the amounts thus accruing but of the stipulated monthly payments. Renewal commissions accrued to the credit of the taxpayer for the year 1944 in the sum of $47,174.98 and in even larger amounts for 1945 and 1946. By 1949, however, they had decreased to $26,313.77. They were collected by the company and deposited in its bank account. It made available to the taxpayer no amount in excess of $1000 per month and the latter did not receive income from Northwestern on account of commissions subsequent to his retirement in any amount in excess of those reported by him.

The Commissioner assessed a deficiency in the sum representing the excess of the accrued commissions over and above $1000

per month. The Tax Court held that the taxpayer should account only for the commissions actually received, that is, $1000 per month, holding that the issue turned on the recognition to be given the second agreement; that it was by giving recognition only to the first one that the commissioner had "any semblance of reason for his determination"; that, inasmuch as the parties had a right to make the first agreement, they had a right to make the second; that the court's only concern was whether the contract actually existed and was intended as a "real, genuine, bona fide agreement," and that the record disclosed no reason why full legal effect should not be accorded the second agreement, which the taxpayer had entered into prior to the date when any of the payments in question were to begin.

Section 22(a) of the Internal Revenue Code provides that gross income shall include all gains of whatever kind and in whatever form "paid"; Section 42, that all items of gross income shall be included in the income for the taxable year "in which received by the taxpayer," unless other methods of accounting under Section 41 control. Section 41 permits income to be computed in accord with the method of accounting regularly employed in keeping the books of the taxpayer. Under Treasury Regulation 111, Section 29.42–1 all gains are to be included in income for "the taxable year in which they are received." The taxpayer was on a cash basis.

The amended contract was in the nature of a novation, that is, a substitution of a new agreement or obligation for an old one which was thereby extinguished. *Hodiamont Bank v. Livingstone,* 8 Cir., 35 F.2d 18. To be valid of course, such a contract must be supported by a consideration. Here, the extinguishment of the original obligation was consideration for the new agreement and the new promise consideration for the release of the old, each being consideration for the other. Consequently the rights of the parties are to be determined entirely by the new contract. Under its terms the taxpayer was to receive commissions at the periods and in the fixed amounts stipulated. He was on a cash basis. He had no right to demand or to receive anything in addition to what he had agreed to accept, namely, $1000 per month.

The case is fully controlled, we think, by the reasoning in *Massachusetts Mutual Life Insurance Co. v. United States,* 288 U.S. 269. There a policyholder permitted dividends and interest accumulating on his policies to remain on deposit with the company at interest. After observing that the regulation purported to require the policyholder to report interest credited to him and that the commissioner therefore contended that crediting the income constituted a "constructive payment," the court said: "This regulation has, however, not been applied in any case where in-

come has been credited to another by a taxpayer employing the cash receipts and disbursements method of accounting; and specifically it has not been invoked to require policyholders to report as income the dividends or interest credited to them in cases such as this. No tax is demanded of them until actual receipt of the money. The constructive payment theory is, we think, untenable." Similar principles are announced in *Musselman Hub-Brake Co. v. Commissioner,* 6 Cir., 139 F.2d 65; *Keith v. Commissioner,* 2 Cir., 139 F.2d 596, 154 A.L.R. 931. Various decisions of the Tax Court are in accord. . . .

The cases cited by the Commissioner, we think, do not support the doctrine he invokes. In *Lucas v. Earl,* 281 U.S. 111, a husband contracted with his wife that earnings which were then accruing would thereafter belong one-half to her. In *Helvering v. Eubank,* 311 U.S. 122, the taxpayer had been a general agent of an insurance company and had retired. An old contract was superseded by another, changing the installments and dates. There, however, the taxpayer assigned his right to receive the payments to another and the court held that thereby he had realized the economic benefit. In *Helvering v. Horst,* 311 U.S. 112, the taxpayer had made an assignment of uncollected income to a third person. The court pointed out that not all economic gain is taxable; that realization of income is the taxable event rather than acquisition of the right to receive it and that realization is ordinarily not deemed to occur until the income is paid, but that the taxpayer may be said to have realized the income when he takes the last step to obtain the fruition of the economic gain. It will be observed that in each of these cases the taxpayer had effectually received the accrued income with which he was charged. In other words, by assigning it, he took dominion over it, converted it to his own use and treated it as a property right, thus realizing its full economic benefit.

This case is far removed from such decisions. Here the parties were confronted by a situation where inconvenience and resulting dissatisfaction came to the retired agents by reason of the constantly decreasing payments made by the company under the original contract. To relieve the situation, the company and the taxpayer, after full and complete negotiations, before retirement of the agent, agreed to abrogate and annul the old contract, to substitute a new one and thus to improve the unsatisfactory posture of affairs. The taxpayer did not reduce to his immediate possession or to his present enjoyment anything that might thereafter accrue to him. He made no assignment; he took no dominion over the accrued commissions other than to agree to receive them in cash installments as they matured under the contract. He did nothing to charge himself with the economic benefit to be derived from the accruing commissions but, on the con-

trary, let them accumulate under an agreement whereby the company was to pay the same amount every month rather than constantly decreasing amounts.

We think the Tax Court was right. Its decision is

Affirmed.

Notes

(A) The Commissioner at first published his formal Nonacquiescence in this decision. See 1952–2 Cum.Bull. 5. After extensive further consideration, he has now withdrawn that Nonacquiescence, and has published his formal Acquiescence. 1960–1 Cum.Bull. ——. See also Rev.Rul. 60–31, 1960–1 Cum.Bull. ——, which gives an extensive discussion of the Treasury's views in this area.

(B) *Deferred compensation plans.* In recent years, many plans have developed under which compensation for personal services is deferred until a later year, in one form or another. Thus the author may receive royalties over a period of time, instead of as the books are sold; or the baseball player may receive payment over a period of several years instead of in the year he plays. Another plan is to make an arrangement with a retiring business executive under which he may (a) agree not to compete, and (b) agree further to hold himself available for consultation as may be desired up to a certain number of days a year. In return the company agrees to pay him so much a year as long as he lives. Ordinarily he receives this amount in addition to whatever regular pension arrangement has been made for him. The Treasury now takes a rather favorable view of these arrangements, and, with appropriate care, they may be carried out in a wide variety of circumstances. See Rev.Rul. 60–31, 1960–1 Cum.Bull. ——.[1]

In *Drysdale v. Commissioner,* 277 F.2d 413 (C.A.6th, 1960), the employer made payments to a trust for one of its executives. It was provided that payments would be made from the trust on the employee's retirement, at a fixed rate per month. The court held that nothing was taxable to the employee at the time the payments were made to the trust.

Under such an arrangement, when are the royalties deductible to the book publisher or when are the payments deductible by the employer—in the case of the ball player, or in the case of the business executive?

(C) *Pension plans.* Pension, profit sharing and "stock bonus" plans are now extensively covered by secs. 401 to 404 of the 1954 Code. If the plan is an approved plan, which means that it must meet certain conditions prescribed in the statute, chief of which is an element of nondiscrimination among employees, then the employer's contributions to it are not taxable as income to the

1 See also Neal, "Deferred Compensation: Qualifying for Non-Qualified Treatment," 13 Vanderbilt L.Rev. 461 (1960); Lasser and Rothschild, "Deferred Compensation for Executives," 33 Harv.Bus.Rev. 89 (1955); Childs, "Deferred Compensation Plans for Executives," 31 Taxes 1007 (1953); McCarthy, "A Survey of Types of Supplementary Compensation for Executives," 30 Taxes 878 (1952).

employee when made, though they are deductible by the employer. The pension trust or fund is itself tax-exempt. The employee becomes taxable when he receives payments under the plan.

For a detailed analysis of the requirements for the qualification of stock bonus, profit sharing, pension and annuity plans, see an extensive "Compilation of guides applicable to the qualification of stock bonus, pension, profit sharing, and annuity plans" in Rev.Rul. 57–163, 1957–1 Cum.Bull. 128.[2]

Prepaid Income

ASTOR HOLDING CO. v. COMMISSIONER

United States Circuit Court of Appeals, Fifth Circuit, 1943. 135 F.2d 47.

MCCORD, CIRCUIT JUDGE. . . . The taxpayer constructed a building in the City of Miami, Florida, for the purpose of leasing it to one David Rosner. On July 2, 1936, the parties entered into a lease for a term of ten years beginning November 1, 1936, and ending October 31, 1946. Paragraph II of the lease provided for payment of an annual rental of $21,390.00, and an immediate advance payment of $17,500.00 as "part payment of the tenth year's rent", with the balance due on the tenth year's rent to be paid in January and February, 1946. The provision requiring the advance payment follows:

"The sum of $12,500.00 upon the signing of the within lease, receipt whereof is hereby acknowledged, and the sum of $2500.00 on or before November 1, 1936, and the sum of $2500.00 on or before April 1, 1937, which sums total the sum of $17,500.00, and shall constitute part payment of the tenth year's rent under the terms of this lease, and the balance of said tenth year's rent shall be paid in the following manner:

"On or before January 1st, 1946, the sum of $1,000.00
"On or before January 15th, 1946, the sum of $2,500.00
"On or before February 1st, 1946, the sum of $390.00."

Both the taxpayer and the Commissioner recognize this to be settled law: An amount paid to a lessor as rent in advance is taxable income in the year of its receipt. *United States v. Boston & Providence R. R. Corp.*, 1 Cir., 37 F.2d 670; *Renwick v. United States*, 7 Cir., 87 F.2d 123; *Commissioner v. Lyon*, 9 Cir., 97 F.2d 70. If an amount is deposited with a lessor merely as security for the performance of covenants, with no present right or claim of full ownership in the lessor, it is not treated as taxable income unless and until something happens to make the deposit, or a por-

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2 See also Goodman, "How Reorganizations Affect Pension and Profit-Sharing Plans," 38 Taxes 155 (1960); Simons, "Cost Factors in Small Pension Plans," 36 Taxes 19 (1958); Lindquist, "Pension and Profit Sharing Trusts under the Internal Revenue Code of 1954," 33 Taxes 30 (1955).

tion of it, the property of the lessor. *Clinton Hotel Realty Corp. v. Commissioner,* 5 Cir., 128 F.2d 968; *Warren Service Corp. v. Commissioner,* 2 Cir., 110 F.2d 723. Whether a payment falls into one category or the other depends upon the facts of the particular case. Decision here turns, therefore, on whether the payment of $17,500.00 to the lessor under the above-quoted provisions of Paragraph II of the lease was an advance payment of part of the rent for the tenth year, as found by the Commissioner and the Board, or whether it was, as contended by the taxpayer, merely a non-taxable deposit of security within the holding of the *Clinton Hotel* case, *supra.*

The payment involved in the *Clinton Hotel* case was "always referred to as a 'security' or a 'deposit' ", and it was "obvious that there were many things to which it might become applicable besides the tenth year's rent". Also, the lessor was required to account not only for the principal amount of the deposit but also for $1,000.00 per year as interest on the principal. 128 F.2d 970.

On its facts the case at bar is clearly distinguishable from the *Clinton Hotel* case. Here the lease refers to the payment of the $17,500.00 as "part payment of the tenth year's rent", and a reading of the lease in its entirety shows that the parties intended that the payment be so applied. The lessor was not required to account for interest on the payment, and for aught that appears the lessor could use the advance payment as its own money. We think it clear that the payment was, as found by the Board, an advance "part payment" of rent for the tenth year; that it was received in the taxable fiscal year by the petitioner, "unrestricted as to its use"; and the full amount was taxable as income in that year.

The decision of the Board is without error.

Affirmed.*

Notes

Note these two cases, decided on the same day:

(1) In *John Mantell,* 17 T.C. 1143 (1952), the taxpayer received a sum as lessor on the execution of a lease. The lease provided that the payment was a "security deposit," and that it was to be returned on the termination of the lease if the lessee was not then in default. It did not provide for the payment of interest or that the deposit should be held in a separate fund. It was held that the deposit was not income to the lessor in the year it was made.

* Hirsch Improvement Co. v. Commissioner, 143 F.2d 912 (C.C.A.2d, 1944), is in accord. These cases, and others, are discussed in Rosenberg, "Advance Payments in Sale and Lease Transactions," 24 Taxes 243 (1946). A recent case to the same effect is Hyde Park Realty, Inc. v. Commissioner, 211 F.2d 462 (C.A.2d, 1954).

(2) In *Jack August,* 17 T.C. 1165 (1952), the taxpayer, as lessor, entered into a lease in 1945 and received payments which were designated by the lease as a part of "the term rental" under the lease. Later in the same year, a new lease was entered into between the parties covering the same term. Under this lease the amounts already paid were stated to be security deposits, to be applied by the lessor only if the lessee defaulted. The court held that there was no mistake in executing the earlier lease. The payments received under it were income, and this fact was not changed by the subsequent execution of a new lease.

See, generally, "Lessor's Security Arrangements and the Internal Revenue Code," 25 U. of Chi.L.Rev. 508 (1958).

The general principle of the *Astor Holding Co.* case has long been applied throughout the tax law. An item has been regarded as income (even on the accrual basis) at least as soon as it was actually received. This was a point where tax accounting was not consistent with standard accounting principles, and there were many discussions of the problem.[1]

This question arose, for example, when it was ruled that magazine subscriptions paid in advance were income, even though there was a liability to furnish magazines in future years. G.C.M. 20021, 1938–1 Cum.Bull. 157. This is now covered by sec. 455 of the Code, which was added by the Technical Amendments Act of 1958. This provides an opportunity for taxpayers to elect to have such income taxed only as earned; and subsection (e) expressly allows taxpayers who have used a method of accounting for prepaid subscription income to continue to use that method. This new section should take care of the basic problems in this area.

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[1] See Smith and Butters, Taxable and Business Income (1949); Lasser and Peloubet, "Tax Accounting v. Commercial Accounting," 4 Tax L.Rev. 343 (1949); "Accounting Principle v. Tax Practice: Treatment of Deferred Credits and Reserves," 61 Harv.L.Rev. 1010 (1948); Seghers, "Tax Accounting Compared with Recognized Accounting Principles," 1 Nat.Tax J. 341 (1948); Edelmann, "Is Income Tax Accounting 'Good' Accounting Practice?" 24 Taxes 112 (1946); Hulse, "Can the Cash Basis of Reporting Be Justified Now?" 24 Taxes 139 (1946); Gutkin and Beck, "Tax Accounting v. Business Accounting—The Emasculation of Section 41," 79 J. of Accountancy 130 (1945); Montgomery, "Administrative Tax Accounting Fallacies in Section 41," 78 J. of Accountancy 14 (1944).

Expenses Paid in Advance

COMMISSIONER v. BOYLSTON MARKET ASS'N

United States Circuit Court of Appeals, First Circuit, 1942. 131 F.2d 966.

MAHONEY, CIRCUIT JUDGE. The Board of Tax Appeals reversed a determination by the Commissioner of Internal Revenue of deficiencies in the Boylston Market Association's income tax of $835.34 for the year 1936, and $431.84 for the year 1938, and the Commissioner has appealed.

The taxpayer in the course of its business, which is the management of real estate owned by it, purchased from time to time fire and other insurance policies covering periods of three or more years. It keeps its books and makes its returns on a cash receipts and disbursements basis. The taxpayer has since 1915 deducted each year as insurance expenses the amount of insurance premiums applicable to carrying insurance for that year regardless of the year in which the premium was actually paid. This method was required by the Treasury Department prior to 1938 by G.C.M. 13148, XIII–1 Cum.Bull. 67 (1934). Prior to January 1, 1936, the taxpayer had prepaid insurance premiums in the amount of $6,690.75 and during that year it paid premiums in an amount of $1082.77. The amount of insurance premiums prorated by the taxpayer in 1936 was $4421.76. Prior to January 1, 1938, it had prepaid insurance premiums in the amount of $6148.-42 and during that year paid premiums in the amount of $890.47. The taxpayer took a deduction of $3284.25, which was the amount prorated for the year 1938. The Commissioner in his notice of deficiency for the year 1936 allowed only $1082.77 and for the year 1938 only $890.47, being the amounts actually paid in those years, on the basis that deductions for insurance expense of a taxpayer on the cash receipts and disbursements basis is limited to premiums paid during the taxable year.

We are asked to determine whether a taxpayer who keeps his books and files his returns on a cash basis is limited to the deduction of the insurance premiums actually paid in any year or whether he should deduct for each tax year the pro rata portion of the prepaid insurance applicable to that year. The pertinent provisions of the statute are Sections 23 and 43 of the Revenue Act of 1936.

This court in *Welch v. DeBlois,* 1 Cir., 1938, 94 F.2d 842, held that a taxpayer on the cash receipts and disbursements basis who made prepayments of insurance premiums was entitled to take a full deduction for these payments as ordinary and necessary business expenses in the year in which payment was made despite the fact that the insurance covered a three-year period.

The government on the basis of that decision changed its earlier G.C.M. rule, supra, which had required the taxpayer to prorate prepaid insurance premiums. The Board of Tax Appeals has refused to follow that case in *George S. Jephson v. Com'r,* 37 B.T.A. 1117; *Frank Real Estate & Investment Co.,* 40 B.T.A. 1382, unreported memorandum decision Nov. 15, 1939, and in the instant case. The arguments in that case in favor of treating prepaid insurance as an ordinary and necessary business expense are persuasive. We are, nevertheless, unable to find a real basis for distinguishing between prepayment of rentals, *Baton Coal Co. v. Commissioner,* 3 Cir., 1931, 51 F.2d 469, certiorari denied 284 U.S. 674, 52 S.Ct. 129, 76 L.Ed. 570; *Galatoire Bros. v. Lines,* 5 Cir., 1928, 23 F.2d 676; See *Main & McKinney Building Co. v. Commissioner,* 5 Cir., 1940, 113 F.2d 81, 82, certiorari denied 311 U.S. 688, 61 S.Ct. 66, 85 L.Ed. 444; bonuses for the acquisition of leases, *Home Trust Co. v. Commissioner,* 8 Cir., 1933, 65 F.2d 532; *J. Alland & Bro., Inc. v. United States,* D.C. Mass.1928, 28 F.2d 792; bonuses for the cancellation of leases, *Steele-Wedeles Co. v. Commissioner,* 30 B.T.A. 841, 842; *Borland v. Commissioner,* 27 B.T.A. 538, 542; commissions for negotiating leases, see *Bonwit Teller & Co. v. Commissioner,* 2 Cir., 1931, 53 F.2d 381, 384, 82 A.L.R. 325, and prepaid insurance. Some distinctions may be drawn in the cases cited on the basis of the facts contained therein, but we are of the opinion that there is no justification for treating them differently insofar as deductions are concerned. All of the cases cited are readily distinguishable from such a clear cut case as a permanent improvement to a building. This latter is clearly a capital expenditure. See *Parkersburg Iron & Steel Co. v. Burnet,* 4 Cir., 1931, 48 F.2d 163, 165. In such a case there is the creation of a capital asset which has a life extending beyond the taxable year and which depreciates over a period of years. The taxpayer regardless of his method of accounting can only take deductions for depreciation over the life of the asset. Advance rentals, payments of bonuses for acquisition and cancellation of leases, and commissions for negotiating leases are all matters which the taxpayer amortizes over the life of the lease. Whether we consider these payments to be the cost of the exhaustible asset, as in the case of advance rentals, or the cost of acquiring the asset, as in the case of bonuses, the payments are prorated primarily because the life of the asset extends beyond the taxable year. To permit the taxpayer to take a full deduction in the year of payment would distort his income. Prepaid insurance presents the same problem and should be solved in the same way. Prepaid insurance for a period of three years may be easily allocated. It is protection for the entire period and the taxpayer may, if he desires, at any time surrender the insurance policy. It thus is clearly an asset having a longer

life than a single taxable year. The line to be drawn between capital expenditures and ordinary and necessary business expenses is not always an easy one, but we are satisfied that in treating prepaid insurance as a capital expense we are obtaining some degree of consistency in these matters. We are, therefore, of the opinion that *Welch v. DeBlois,* supra, is incorrect and should be overruled.

The decision of Board of Tax Appeals is affirmed.

Notes and Problems

(A) The case is discussed in "Comm'r v. Boylston Market Ass'n: Deduction of Fire Insurance Premiums by a Taxpayer on the Cash Basis," 56 Harv.L.Rev. 818 (1943).

Waldheim Realty & Inv. Co. v. Commissioner, 245 F.2d 823 (C.A.8th, 1957), is in conflict with the *Boylston Market* case. It is noted in 44 Val.L.Rev. 120 (1958).

(B) The taxpayer was indebted on a number of notes. During the taxable year he paid the interest on some of them for three years in advance. May he deduct the interest so paid? *John D. Fackler,* 39 B.T.A. 395 (1939), Acq. 1939–1 Cum.Bull. 11. See "Prepaid Interest," 28 So.Calif.L.Rev. 72, (1954).

However, where a taxpayer prepaid anticipated medical expenses, it was held that he was not entitled to deduct the amount so paid. *Robert S. Bassett,* 26 T.C. 619 (1956). It was held that this was equivalent to a deposit. There was no present liability which was discharged by the payment. See "Pre-paid Medical Expenses—The Nondeductible Deduction," 9 Stanford L.Rev. 597 (1957).

(C) The taxpayer borrowed money on his life insurance policy. In 1933, interest was due, and by the terms of the contract it was added to the principal. Is the taxpayer, on the cash basis, entitled to a deduction for "interest paid"? *Prime v. Commissioner,* 39 B.T.A. 487 (1939). See Conrad, "The Deduction for Interest on Life Insurance Loans on a Cash Basis," 20 Taxes 579 (1942).

(D) In *Cleaver v. Commissioner,* 158 F.2d 342 (C.C.A.7th, 1946), the taxpayer borrowed money by giving a note, which was discounted. He received from the bank the face amount of the note, less the discount. It was held that he was not entitled to a deduction for interest paid until he paid the note. But compare *Newton A. Burgess,* 8 T.C. 47 (1947), where the taxpayer borrowed money and used it to pay interest on another note. It was held that he was entitled to a deduction for interest paid.

Suppose a loan on a life insurance policy is outstanding when the insured dies. The company deducts the amount of the loan and all accrued interest from the face amount of the policy, and pays the balance to the beneficiary of the policy. Is anyone entitled to a deduction for interest paid? In *Estate of Pat E. Hooks,* 22 T.C. 502 (1954), the beneficiary was the wife and she filed a joint return for the year of death. It was held that the interest was deductible either by the husband or by the wife, and hence was deductible on the joint return.

(E) The taxpayer executed an agreement of guaranty, undertaking to make up a deficiency in the realization of certain assets of a closed bank in an amount not exceeding $500,000. In 1931, in order to put his obligation into "bankable form," the taxpayer executed his note for $125,000, and endorsed another note for a like amount, and the successor bank agreed that his ultimate liability should not exceed $250,000. In 1932, the bank pressed for a settlement, and the taxpayer gave his note to the bank for $250,000, with security, and received back the two previous notes. It was found as a fact that this was regarded by both parties as a final payment of the two previous notes. Is the taxpayer entitled to a deduction for a loss in 1932? *Helvering v. Price*, 309 U.S. 409 (1940). See also *Eckert v. Burnet*, 283 U.S. 140 (1931).

Income Received Subject to Contingencies or Liabilities

In *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932), a company claimed to own oil land, but in 1916 a receiver was appointed to operate the property at the suit of the United States which also claimed the land. In 1917, the District Court dismissed the suit, and the receiver paid $172,000 to the company as the proceeds of his operation. The United States took an appeal to the Circuit Court of Appeals, which affirmed the decree in 1920; and in 1922 an appeal to the Supreme Court was dismissed. In the tax case, the Supreme Court held that the money was not income in 1916, since it was then uncertain whether the company would ever get it. But the sum received in 1917 was held income for that year, regardless of the basis on which the books were kept. The Court said (p. 424): "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to the money, and even though he may still be adjudged liable to restore its equivalent. . . . If in 1922 the government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year."

See Freeman, "Tax Accrual Accounting for Contested Items," 56 Mich.L.Rev. 727 (1958).

UNITED STATES v. LEWIS

Supreme Court of the United States, 1951. 340 U.S. 590.

MR. JUSTICE BLACK delivered the opinion of the Court.

Respondent Lewis brought this action in the Court of Claims seeking a refund of an alleged overpayment of his 1944 income tax. The facts found by the Court of Claims are: In his 1944 income tax return, respondent reported about $22,000 which he had received that year as an employee's bonus. As a result of subsequent litigation in a state court, however, it was decided that respondent's bonus had been improperly computed; under compulsion of the state court's judgment he returned approximately

$11,000 to his employer. Until payment of the judgment in 1946, respondent had at all times claimed and used the full $22,000 unconditionally as his own, in the good faith though "mistaken" belief that he was entitled to the whole bonus.

On the foregoing facts the Government's position is that respondent's 1944 tax should not be recomputed, but that respondent should have deducted the $11,000 as a loss in his 1946 tax return. See G.C.M. 16730, XV–1 Cum.Bull. 179 (1936). The Court of Claims, however, relying on its own case, *Greenwald v. United States,* 57 F.Supp. 569, held that the excess bonus received "under a mistake of fact" was not income in 1944 and ordered a refund based on a recalculation of that year's tax. 91 F.Supp. 1017. We granted certiorari, 340 U.S. 903, because this holding conflicted with many decisions of the courts of appeal, see, *e. g., Haberkorn v. United States,* 173 F.2d 587, and with principles announced in *North American Oil v. Burnet,* 286 U.S. 417.

In the *North American Oil* case we said: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." 286 U.S. at 424. Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim. Nor has the "claim of right" doctrine been impaired, as the Court of Claims stated, by *Freuler v. Helvering,* 291 U.S. 35, or *Comm'r v. Wilcox,* 327 U.S. 404. The *Freuler* case involved an entirely different section of the Internal Revenue Code, and its holding is inapplicable here. 291 U.S. at 43. And in *Comm'r v. Wilcox, supra,* we held that receipts from embezzlement did not constitute income, distinguishing *North American Oil* on the ground that an embezzler asserts no "bona fide legal or equitable claim." 327 U.S. at 408.

Income taxes must be paid on income earned (or accrued) during an annual accounting period. Cf. I.R.C., §§ 41, 42; and see *Burnet v. Sanford & Brooks Co.,* 282 U.S. 359, 363. The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, Law of Federal Income Taxation, § 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.*

Reversed.

* It has been suggested that it would be more "equitable" to reopen respondent's 1944 tax return. While the suggestion might work to the advantage of this taxpayer, it could not be adopted as a general solution because, in many cases, the three-year statute of limitations would preclude recovery. I.R.C., § 322(b).

MR. JUSTICE DOUGLAS, dissenting.

The question in this case is not whether the bonus had to be included in 1944 income for purposes of the tax. Plainly it should have been because the taxpayer claimed it as of right. Some years later however it was judicially determined that he had no claim to the bonus. The question is whether he may then get back the tax which he paid on the money.

Many inequities are inherent in the income tax. We multiply them needlessly by nice distinctions which have no place in the practical administration of the law. If the refund were allowed, the integrity of the taxable year would not be violated. The tax would be paid when due; but the government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that payment was made on money which was not income to the taxpayer.

Notes

(A) A similar result was reached in *Healy v. Commissioner,* 345 U.S. 278 (1953), where three taxpayers, on the cash basis, received salaries from a closely held corporation. They reported the amount as income in the year received. Thereafter, the Commissioner ruled that the salaries were unreasonable, and disallowed part of the payments as deductions to the employing corporation. This resulted in a deficiency for the corporation which it was unable to pay. The government then proceeded against the taxpayers as transferees of the corporation, and succeeded in collecting from them a portion of the liability determined against the corporation.

The taxpayers contended that they should be allowed to deduct the amounts so paid in the years in which they had received the salaries. They contended that, as things had worked out, they had received the salaries, to the extent repaid, as constructive trustees for the corporation. The Court held that the salaries were received under a "claim of right," and that the repayments were deductible only for the year in which the repayments were made.

(B) This matter is now materially affected by **sec. 1341** of the 1954 Code, a new provision in the new Code, which, if the amount of the deduction is over $3,000, gives the taxpayer, in effect, the benefit of the deduction for either the earlier or the later year, as may be more advantageous to him.[1]

(C) Consider the converse situation. Suppose a taxpayer makes a payment in an earlier year for which he takes a deduction. Later it appears that the payment was erroneous or excessive, and he receives a refund. Must the refund be included

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[1] For a discussion of the problems under this section see Webster, "The Claim of Right Doctrine: 1954 Version," 10 Tax L.Rev. 381 (1955).

For consideration under the 1939 Code, see Gelfand, "The Claim of Right Doctrine," 33 Taxes 726 (1955).

in income in full, or may it be used to reduce the prior deduction? Does the new statutory provision have any application to this question?

(D) Suppose the payment is a pure mistake. The clerk in the comptroller's office hits a wrong key, and a pay check sent out late in December is for $1,600 instead of $600. The employee receives it, notes the increased amount, thinks it is an unexpected Christmas bonus, and endorses and deposits the check. Early in January, the error is discovered, and he pays back the extra $1,000. Is he to be treated as having income in December and a deduction in January?

(E) Suppose the receipt and the repayment come in the same tax year. Does it make any difference how the matter is handled in such a case? Compare *Estate of Lloyd E. Crellin,* 17 T.C. 781 (1951), where a corporation declared and paid a dividend, acting on the advice of an accountant that it was necessary to do so to avoid the personal holding company tax. Later it was found that the advice was wrong, and in the same year as that of payment, the dividend was rescinded and repaid. It was held that the dividend resolution established an obligation, even though it had been based upon a mistaken notion of the tax law, and that the payment was a dividend which could not thereafter be rendered non-taxable by repayment. The repayment was, in effect, a contribution to the capital of the corporation, and not deductible.

Bunched Income

Secs. 1301–1307 of the 1954 Code, as Amended

These provisions of the 1954 Code have been amended three times. In 1955, sec. 1304, relating to "Compensatory Damages for Patent Infringement," was added. In 1957, sec. 1305, relating to "Breach of Contract Damages," was enacted. See Patterson, "Breach of Contract Damages," 36 Taxes 617 (1958). See also Cutler, "Taxation of the Proceeds of Litigation," 57 Col.L. Rev. 470 (1957). In 1958, sec. 1306, relating to "Damages for Injuries under the Antitrust Laws," was added. Would it be feasible to enact a general statute which would be applicable to all situations of this character?

See "A Comparison of The Tax Treatment of Authors and Inventors," 70 Harv.L.Rev. 1419 (1957); Kragen and Barton, "The Tax Dilemma of the Entertainer," 31 So.Calif.L.Rev. 390 (1958).

ROBERTSON v. UNITED STATES

Supreme Court of the United States, 1952. 343 U.S. 711.

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

[The facts of the case are stated, and the first portion of the opinion is set out, at page 159 above. This should be re-examined before considering the second portion of the opinion, below, which deals with the question of the applicability of sec. 107 of the 1939 Code (now found in sec. 1302 of the 1954 Code) to the payment.]

II.

Section 107(b) defines "artistic work" as the "musical" or "artistic composition" of an individual, "the work on which . . . covered a period of thirty-six calendar months or more from the beginning to the completion" of the composition.[1] In case the gross income from a particular artistic work in the taxable year is not less than a particular percentage (not material here), the tax attributable to the income of the taxable year may be computed as though it had "been received ratably over that part of the period preceding the close of the taxable year but not more than thirty-six calendar months." The question is whether the amount of the prize should be taxed ratably over the 36 months ending with the close of 1947 (the taxable year in which it was received) or over the last 36 months of the period (1937 to 1939) when petitioner wrote the symphony.

The phrase in question, as it originated (H.R. 7378, 77th Cong., 2d Sess., § 128) read "ratably over the period of thirty-six calendar months ending with the close of the taxable year." In that form the present tax would have been computed as the Commissioner contended, *viz.* the tax would be laid over a period of 36 months extending back from the close of the taxable year. The change in wording does not seem to us to have made a change in meaning. The present words "ratably over that part of the period preceding the close of the taxable year but not more than thirty-six calendar months" would on their face seem to refer to a period ending with the close of the taxable year and extending back a maximum of 36 months. That wording was adopted in order to treat the income as though it had "been received ratably over (1) the part of the period of the work which preceded the close of the taxable year, or (2) a period of 36 calendar months, whichever of such periods is the shorter." See S.Rep. No.1631, 77th Cong., 2d Sess., p. 109. The House Conferees, in agreeing to the change, stated that it "clarifies the language of the House bill." H.R.Conf.Rep.No.2586, 77th Cong., 2d Sess., p. 43. That history strongly suggests that the purpose was not to change the allowable period of allocation from one ending with the close of the taxable year to one covering any 36 months in the past when the work was done, but to prevent tax reduction by proration of income over a period of work greater than the duration of the work preceding the close of the taxable year. That is the construction given by Treasury Regulations 111, §

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1 [This period has been changed to 24 months in section 1302(a)(2) of the 1954 Code.]

29.107–2;[1] and while much more could be said, it seems to us that that construction fits the statutory scheme.

Affirmed.

MR. JUSTICE JACKSON dissents.

Notes

(A) The provision now found in sec. 1301 of the 1954 Code was first enacted in 1939 as sec. 107 of the former Code. It was extensively amended in 1942. The provision now found in sec. 1303 was added by the Revenue Act of 1943. Note that the several sections now deal with three somewhat different problems: (1) "bunched income" from personal services (sec. 1301), and (2) "bunched income" from an artistic work or invention (sec. 1302), and (3) "back pay" (sec. 1303). The latter does not necessarily involve any question of "bunching," but comes into operation, when the conditions are met, simply because of delay in making the payment.[2]

(B) In *Stallforth v. Commissioner,* 6 T.C. 140 (1946), the taxpayer received compensation in 1941 for services rendered from

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1 Section 29.107–2 provides in part:

"The method of allocating the gross income from the artistic work or invention to the taxable years in which falls any of the calendar months (not exceeding 36 calendar months) included within the part of the period of work which precedes the close of the current taxable year may be illustrated by the following examples:

"*Example (1).* On October 1, 1942, A, an individual, who makes his returns on a calendar year basis and on the basis of cash receipts and disbursements, receives $36,000 in full payment for a musical composition, the work on which was commenced by A on July 10, 1938, and completed on January 29, 1943. Although the period of work covers 55 calendar months, allocations may be made to only the last 36 calendar months included within the part of the period of work which precedes the close of 1942 (the current taxable year). Therefore, $1,000 ($36,000 divided by 36) must be allocated to each of the 36 calendar months preceding January 1, 1943. Accordingly, $12,000 is allocated to 1940, $12,000 to 1941, and $12,000 to 1942 (the current taxable year).

"*Example (2).* Assume the same facts as in example (1) except that the period of work was commenced by A on July 1, 1941, and completed on September 1, 1944. Although the period of work covers 38 calendar months, allocations may be made to only the 18 calendar months which are included within the part of the period of work which precedes the close of 1942 (the current taxable year). Therefore, $2,000 ($36,000 divided by 18) must be allocated to each of 18 calendar months preceding January 1, 1943. Accordingly, $12,000 is allocated to 1941, and $24,000 to 1942 (the current taxable year)."

2 For consideration of questions under these provisions, see Taylor, "Tax Relief for Income Attributable to Several Years," 36 Taxes 701 (1958); Pilpel, "Tax Law Affecting Copyrights: 1954–1956," 35 Taxes 76 (1957); Bonazura, "Compensation for Services over Several Taxable Years," 107 J. of Accountancy 57 (March, 1959); Bayly, Minimizing Taxes on Professional Income (1953); Bayly, "Deduction Benefits under Code Section 107," 31 Taxes 730 (1953); Lasser, "Long Term Compensation: Tax Limitation Benefits under Section 107(a)," 31 Taxes 42 (1953); "Current Problems under I.R.C. Section 107," 48 Northwestern U.L.Rev. 51 (1953); Vernon, "Some Current Problems under Section 107," 1 Tax L.Rev. 357 (1946); Gordon, "Scope of Sections 107(a) and (d)," 4 Tax L.Rev. 169 (1949); Swartz, "Authors and the Federal Income Tax," 26 Taxes 51 (1948).

1935 through 1940. The taxpayer was a resident of the United States in 1941, but he was a bona fide non-resident during 1936 and 1937, and income received by him during those years would have been excluded from tax under what is now sec. 911 of the 1954 Code. It was held that all of the income was taxable. The allocation over the years is for the purpose of computing the tax liability for 1941, and does not mean that the income shall for all purposes be treated as if it had been received in the earlier years.

(C) Two questions which arose under the earlier law have now been covered by express provisions in the 1954 Code:

(1) A taxpayer performs services from 1944 to 1953, and receives payment in 1953, for which year he files a joint return with his wife. He and his wife have filed joint returns for 1948 and each subsequent year when "income splitting" was allowed. For 1947 and prior years they filed separate returns. In *Hofferbert v. Marshall,* 200 F.2d 648 (C.A.4th, 1952), and in *Ayers J. Stockley,* 22 T.C. 3 (1954), it was held that in computing his tax for 1953 he could make the computation with respect to 1947 and earlier years by dividing the income allocated to those years half to himself and half to his wife on their separate returns. But cf. Rev.Rul. 54–206, 1954–1 Cum.Bull. 94.

For 1954 and subsequent years, sec. 1304(c) of the 1954 Code it is provided that the income shall be regarded only as income of the person who earned it for the purposes of this computation. For an earlier consideration, see Braunfield, "Long Term Compensation and Income Splitting," 26 Taxes 619 (1948).

(2) A partnership performs services from 1944 to 1953, and receives payment in 1953. T is a member of the partnership in 1953, but did not become a member until 1951, after the work was started, and within 36 months before the payment was received. A number of cases held that T might compute his tax by spreading his share of the income over the whole period during which the partnership performed the services.

This is now covered, for 1954 and subsequent years, by sec. 1301(c) of the 1954 Code. For a consideration of the previously existing questions, see "Section 107(a) and the Partnership," 65 Harv.L.Rev. 1193 (1952).

(D) *Amounts received under an annuity, life insurance or endowment contract.* Note the provision of sec. 72(e)(3) of the 1954 Code giving a special rule with respect to amounts received by the insured on the maturity of an endowment policy, or on the surrender of a life insurance or annuity policy. If the amount received is greater than the consideration paid for the policy, the excess is taxable, but the gain can be spread over a period of three years for the purpose of computing the tax.

(E) Another provision of this sort is found in sec. 481(b)(1) of the 1954 Code. Under this, where there is a change of accounting method, the resulting adjustment must be made, but may be spread over a period of three years. See also sec. 481(b)(2) allowing the spreading, in certain cases, over a longer period.

CHARLES SPICER

Tax Court of the United States, 1954. Prentice-Hall T.C. Memo. Opinions Service par. 54,139.

WITHEY, JUDGE. The respondent has determined a deficiency in the income tax of the petitioners for 1947 in the amount of $3,678.33. The issue presented is the correctness of the respondent's action in determining that compensation received by the petitioners should be reduced by a legal fee paid in 1947 to collect the compensation before allocation of the compensation is made to prior years under section 107 of the Internal Revenue Code. Another issue raised by the pleadings has been conceded by the petitioners.[1]

Opinion

Both parties agree that the compensation received by the petitioners for their personal services is to be treated as provided in section 107(a) of the Internal Revenue Code.[2] The sole issue presented is whether the legal fee paid by petitioners in 1947 is deductible in its entirety in that year, as petitioners contend, or whether the legal fee should be offset against the compensation and only the net amount of compensation remaining allocated to the prior years, as respondent contends.

The respondent is aware of our decision in *Weldon D. Smith*, 17 T.C. 135, 144 revd. on another issue (C.A.2, 1953) 203 F.2d 310. In the *Smith* case the petitioner paid $25,000 during 1945 as a legal fee incurred in the settlement and collection of $212,000 back pay. We there held that the entire amount of a legal fee paid to collect back pay was deductible in the year paid. Respondent contends that the case was incorrectly decided and that we should reconsider our position. He argues that since section 107 of the Code permits the taxpayer to allocate the compensation earned to the applicable years, Congress must have intended that the expenses incurred in gaining the compensation should also be so allocated. We said in the *Smith* case in referring to back pay the following:

> "Back pay is afforded the treatment of allocation to applicable years simply because of the existence of section 107

[1] The Findings of Fact are omitted.

[2] (a) Personal Services. If at least 80 per centum of the total compensation for personal services covering a period of thirty-six calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, the tax attributable to any part thereof which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual.

of the Code. Without this section, the entire $212,000 would be income in 1945. Section 107 is silent as to expenses incurred in connection with any collection of back pay, and there are no regulations nor decisions which we have been able to find on the question. To limit application of section 107 to amounts received less expenses connected with collection is not a function for the Court, but rather is a task for the Congress if that is the result which they wish. * * *"

What we said in regard to expenses incurred in connection with the collection of back pay is also applicable to the expenses incurred in connection with the collection of the compensation received by the present petitioners.

We have carefully reviewed our decision in the *Smith* case, but can find no basis in the statute for sustaining the respondent's contention. We, therefore, will continue to follow our opinion in the *Smith* case and we therefore hold that petitioners are entitled to deduct the $15,000 legal fee in 1947.

Decision will be entered under Rule 50.

Notes

(A) What if some other taxpayer now wants to spread his deduction over several years, in accordance with the government's contention in the *Spicer* case? Is he free to do so? Will the government object to the deduction on that basis?

In *Cotnam v. Commissioner*, 263 F.2d 119 (C.A.5th, 1959), the taxpayer recovered a judgment for services rendered over a period of several years. Under a contingent fee arrangement, 40% of the recovery was paid directly to her attorney. The court (Wisdom, J., dissenting) held that this fee should be excluded from the amount of the taxpayer's recovery, thus, in effect, allowing the fee to be spread as a deduction over the same period that was used in computing the tax on the recovery. Is this right? Can it be reached under the present statute? Should the statute be changed? How?

(B) A trustee negligently failed to collect income for several years. Finally he collected the back income and distributed it to the beneficiary all in one year so that the beneficiary had a large tax to pay. The beneficiary sued the trustee to recover the increased tax. The court held that the trustee was not liable. *Wanamaker's Trust Estate,* 340 Pa. 419, 17 A.2d 380 (1941). See also *In re Comstock's Will,* 219 Minn. 325, 339, 17 N.W.2d 656, 664 (1945), where a trustee was required to pay interest because of income lost due to his self dealing, but the beneficiary's claim for reimbursement for tax on the interest was denied.

This situation is now affected by sec. 1305 of the 1954 Code, added in 1957. This relates to "Breach of Contract Damages," and includes recovery for "breach of a fiduciary duty."

(C) In *Rogan v. Mertens,* 153 F.2d 937 (C.C.A.9th, 1946), the taxpayer was an actor. He had a contract with Loew's under which he was to be paid $6,000 a week, and Loew's agreed to pay the taxes which would be assessed against him. He planned to leave the country, and notified the Collector to that effect on August 30, 1938, in order to secure the certificate of income tax clearance now prescribed by sec. 6851(d) of the 1954 Code. In accordance with what is now sec. 6851(a)(1), the Commissioner closed the taxpayer's taxable year on September 1, 1938. The Collector refused to give the taxpayer a certificate of compliance unless he paid tax not merely on his weekly salary but also on the tax which Loew's had undertaken to pay. In order to meet this tax liability, the taxpayer obtained a loan from Loew's, and paid the tax demanded on September 7, 1938. The taxpayer then filed a claim for refund, and brought suit to recover the portion of the tax paid in excess of that due on the weekly salary. Recovery was allowed. The court held that the taxpayer's taxable year having closed on September 1, 1938, he was not taxable in that year on the tax payment. The money was not furnished by Loew's until after that date. Moreover, when furnished, it was a loan, and thus not taxable income even at that date.

(D) *Obligations issued at a discount.* Note the special provision in sec. 454 with respect to obligations issued at a discount. This applies to all non-interest-bearing obligations issued for less than their face or maturity value, whether issued by the United States, or by a state or local government, or by a corporation. Among the most frequently encountered of such obligations are United States Savings Bonds, of the ordinary Series E variety.

If the holder of such bonds is on the cash basis, he will not have interest income until he receives the interest, either at the maturity of the bond, or on earlier cash-in, or, now, during or at the close of the period of extended maturity now provided for these bonds. It is obvious that this arrangement will result in bunching the interest for a number of years into one year with possible undesirable tax consequences. Sec. 454 gives the taxpayer the option, if he so chooses, of including the income in taxable income each year as the bond increases in value. If this election is made, it must be applied to all bonds owned by the taxpayer, and all income already accrued must be included in the return for the year in which the election is made.

See Zafft, "Discount Bonds: Ordinary Income Or Capital Gain?" 11 Tax L.Rev. 51 (1955).

ACCRUAL BASIS

We now turn to a consideration of questions arising on the accrual basis, which, as has been pointed out, is the method of accounting used by most corporate taxpayers, and some individuals (and partnerships and trusts).

In a rough and ready way, it may be said that on the accrual basis items of income are included in the accounts for the year in which they are earned, regardless of when they are received,

and items of deduction are included in the accounts for the year in which they are incurred, regardless of when they are paid. Although this is the general scheme of the accrual basis, the problems of the application of the accrual concept are often far from easy.

OHMER REGISTER CO. v. COMMISSIONER

United States Circuit Court of Appeals, Sixth Circuit, 1942. 131 F.2d 682.

MARTIN, CIRCUIT JUDGE. The taxpayer, Ohmer Register Company, has petitioned for review of the decision of the United States Board of Tax Appeals determining deficiencies in income taxes and excess profit taxes for the calendar year 1936. The petitioner is an Ohio corporation engaged in the business of selling cash registers and other products manufactured by the Ohmer Fare Register Co., a corporation which owns all of petitioner's capital stock.

Consistently since its organization in 1932, the petitioner has kept its books and rendered income tax returns upon the accrual basis. In determining the deficiency, the Board of Tax Appeals upheld the denial by the Commissioner of Internal Revenue of the right of petitioner to deduct from its gross income for 1936, as a regular and necessary item of business expense, a reserve for sales agents' commissions set up on its books as accrued and earned by its agents from sales made by them during 1936.

To clarify the issue presented, it is necessary to discuss in somewhat extended detail the rather complicated agreement between the petitioner and its sales agents. The form of agreement with its sales agents had been in constant use since the inception of petitioner's business in 1932, as likewise had been the method of bookkeeping for tax reference in use by petitioner during 1936.

Two instruments constituted the contract: an agreement known as "Form C-331" and an attached rider designated as "Rider 1-E." The sales agent's agreement, Form C-331, provided that the agent should receive as full compensation for his services and expenses a commission on monies received by the company from the sale of its products as stated in the attached rider, expressly made a part of the agreement; and that these commissions should be paid on the amounts of the total net sales, after deducting discount for quantity orders and for any other allowances to the customer, except cash discounts and "trade-in products" accepted on orders for Ohmer products and paid for by the agent as his property. Should the trade-in allowance not exceed the agent's advance commission, the amount allowed on

the trade-in by him would be deducted from his advance commission on the sale; but, if the trade-in allowance exceeded the advance commission, the agent was required to send in to the company, with the order, his check for the difference between the amount of his advance commission and the amount allowed for the trade-in.

Should a purchaser countermand his order, refuse to accept the product ordered or deliver an exchange product as agreed, or tender a dishonored check; or should the company take back the product sold or commence repossession proceedings, the commission credited on the original transaction was required to be charged back to the agent's commission account. The agent's commission account would be credited with the proper rate of commission on the amount actually paid by the customer, if no reconditioning or repossession expense had been incurred and no refund to the customer made by the company. The agent's commission account would be credited with the commission on the amount actually paid by the customer "after deducting the cost of reconditioning the register and/or cost of repossession."

The agent was required to create and maintain a competent efficient and experienced Service Department and to have on hand at all times a sufficient stock of Ohmer repair parts "to keep all Ohmer products in his territory in satisfactory, efficient operation during the period of the company's guarantee thereon." It was agreed that, in consideration of the commissions to be paid to the agent, he would without charge repair at any time, in compliance with the company's regular guarantee, any Ohmer product "out of order from ordinary use," and in his prescribed territory would also repair any Ohmer product "on which there still remains a period of free repair."

Upon termination of the agreement, the agent's account would be settled by a determination, three months thereafter, of the amount still owing him on his sales; and a statement of his commission account showing commission credits, advances, charge-backs and miscellaneous credits and debits would be rendered. Similar settlements were to be made at subsequent intervals of three months. On this method of settlement, it was provided that if the credit balance of the agent on the books of the company should exceed the total possible commission charge-back, the difference would then be due and payable to the agent. If, however, at any such accounting period the agent's account should show him indebted to the company, he was required to pay the indebtedness immediately, or to make arrangements for its liquidation acceptable to the company.

Provision was made that the agreement in writing should constitute the entire contract between the parties; and that the

contract could not be changed, varied, modified or explained in any manner whatsoever, except by agreement in writing signed by a duly authorized executive of the company.

The foregoing constituted the pertinent provisions of the agreement known as Form C-331, which contained 34 numbered clauses. The attached Rider 1-E, expressly made a part of the contract, contained further pertinent provisions, which will be quoted:

"2. The following rates of commission will be credited to Agent subject to the remaining clauses of this Agreement on all Ohmer Cash Register orders received from Agent and accepted by Company after the effective date of this rider; * * * [advance commission (A) 10%, collection and service commission (B), at varying rates, are set out].

"3. To assist Agent in financing himself, the Company, after its acceptance of an order and after it has received the customer's signed delivery receipt and at least 10% cash with order, and so long as the condition of Agent's account and character of Agent's business warrants, will advance to Agent 10% of the net price of the register or registers after all deductions for discounts and other allowances (except cash discounts and trade-in allowances) have been made. In addition to the above 10% advance commission, the Company will pay Agent a collection and service commission as specified in column (B) above on the balance owing after 10% of the net price of the register or registers has been deducted, and after the money owing has actually been collected from the purchaser and received by the company. The acceptance of a promissory note by Company from a customer shall under no condition be considered as payment of customer's account."

The requirement that the agent should repair Ohmer Cash Registers and products was based upon the petitioner's contracts with its customers in connection with all deferred payment sales and frequently with cash sales, as well, to make free repairs for one year if the purchaser would pay transportation charges to and from the factory. The company was bound to fulfill its obligation to the customer in this respect, whether or not the sales agent fulfilled his assumed obligation to the company.

A sales contract, when signed by the purchaser, was forwarded to the petitioner for acceptance; and, when the merchandise was shipped, the full amount of the sales price was charged upon the petitioner's books to the customer's account and credited to gross income, whether the goods were sold for cash or on a deferred payment plan, evidenced by notes or otherwise. No book entry of sales was made until the goods were shipped. The total amount of the net sale, that is the actual amount to be

paid by the customer after deducting cash discounts and trade-in allowances, was entered from the invoice, irrespective of the amount of cash received with the order.

The Board of Tax Appeals, in its findings of fact, has thus described the manner in which the petitioner made its bookkeeping entries with respect to its agents' commissions:

"After acceptance of the sale order and at the time of the shipment of the cash register sold, entries with respect to the transaction were made on petitioner's 'Commission Record,' under several headings or columns indicating, in substance the following: Date of Sale, Name of Customer, Notes given and Trade-Ins, if any, Net Amount of Sale, per cent of commission as shown by the sales agent's contract, Total Commission; and then under Current Commissions were placed Credits, Commission Earned, and in a second column under Current Commissions, were placed Debits, Check and Charge Backs, which were followed by the heading 'Reserve Commissions,' followed by 'Prospective Commissions,' which latter represent the difference between the total commissions and the amount credited under 'Current Commissions.'

"Commissions were figured at the contract rate upon the sales price and entered upon the petitioner's record in column headed 'Total Commissions.'

"The commissions due the agent when a sale was made, accepted and 10 per cent of the selling price was actually received by the petitioner, were entered in the column of agent's account headed 'Current Commissions.'

"The aggregate total of the balances on the commission accounts of the sales agent was shown on the commission record as 'Prospective Commissions'; and 'Reserve Commissions' were carried on General Ledger Account No. 242–1 under the name 'Reserve for Sales Agents' Commissions,' which it was the practice of the petitioner to set up as a reserve (termed a misnomer by witness for petitioner) in each taxable year and claim a deduction therefor.

"The total commission column also was reflected in the general ledger, in account number 215, named 'Accounts Payable, Unpaid Commissions.'"

Some agents occasionally assigned their commission accounts as collateral to secure bank loans; and, in such instances, the petitioner accepted the assignments without guaranteeing payment of the loans, and issued checks covering the agents' commissions payable to the assignee. There were instances, also, where sales agents were paid their earned commissions before petitioner had received payment from customers on orders upon which the commissions were earned.

The Board of Tax Appeals conceded the right of a taxpayer keeping books and filing income tax returns on the accrual basis, to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business (Section 23 of the Revenue Act of 1936); and conceded, also, that the taxpayer may deduct, as expense incurred, a liability which has accrued during the taxable year, "although payment is not presently due." *United States v. Anderson,* 269 U.S. 422; *American National Co. v. United States,* 274 U.S. 99; *Aluminum Castings Co. v. Routzahn,* 282 U.S. 92. But, pointing out that except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent (*Weiss v. Weiner,* 279 U.S. 333), that "reserves" have a definite meaning and limitation under the taxing statutes (*Brown v. Helvering,* 291 U.S. 193); and that, though a prudent business man often sets up reserves to cover contingent liabilities, such reserves are not necessarily allowable as deductions (*Lucas v. American Code Co.,* 280 U.S. 445), the Board held that the commissions in controversy "were not incurred and definitely fixed" during the taxable year so as to constitute an allowable deduction for income tax purposes, but, on the contrary, were mere "contingent liabilities" of the petitioner. Upon the principles of *Brown v. Helvering, supra,* the manner in which petitioner carried sales agents' commissions upon its books was deemed inconclusive of the right to deduct. It was said that any system which accrues contingent liabilities as expense items does not correctly reflect, but distorts, income. Stating that *United States v. Anderson, supra,* involved "an unconditional liability," the Board held that the instant case involved contingent liabilities, in that all events which determined the liability of the petitioner to pay the sales agents' commissions had not occurred during the taxable year 1936, inasmuch as the commissions were dependent upon collection of the sales prices of the cash registers.

In urging reversal of the Board's decision, the petitioner insists that the items of commission expense set up on its books are not contingent, but are fixed, definite and accrued items of corporate liability, deductible as ordinary and necessary business expense under Section 23 of the Revenue Act; that, even if the liability of petitioner to pay the commissions is considered contingent, the same contingency exists with respect to the income from the identical transactions on which the commissions were earned; that, regardless of the question of contingency, the agents' commissions were never a part of income of the petitioner, but merely constituted funds passing through its hands as a conduit to the agents; and that the petitioner's method of accounting clearly reflects its true income.

The principles which this court applied in *Air-Way Electric Appliance Corporation v. Guitteau,* 6 Cir., 123 F.2d 20, uphold the petitioner in the instant case upon its main contentions. Our conclusion from the findings of fact of the Board of Tax Appeals and the record before us is that both the petitioner and its agents have treated the agents' commissions as earned and as definite obligations of the petitioner entered as such on its books at the time goods were shipped pursuant to accepted orders.

The petitioner kept an "Agent's Commission Ledger Account" book, into which was entered under the heading "Total Commission" the full amount of an agent's commission immediately upon acceptance of a sales order received through him. Thus, the petitioner evidenced its recognition of a specific item of accrued expense as a fixed liability. The fact that the agent might not, in the end, receive his full commission is no more material than that the petitioner might not receive full payment of the purchase price of the article sold. Petitioner's books were kept and its income tax returns were made upon the accrual basis.

The essence of the accrual method of keeping accounts and making returns is that the right to receive and not the actual receipt determines whether an amount should be included in gross income. The right accrues when the right to receive the amount becomes fixed. *Spring City Foundry Co. v. Commissioner of Internal Revenue,* 292 U.S. 182, 184. Correspondingly, the right to deduct an expense item accrues when the fixed obligation is incurred, even though the amount may be diminished by subsequent events. Both sides of the ledger must be treated alike. *Bonded Mortgage Co. of Baltimore v. Commissioner of Internal Revenue,* 4 Cir., 70 F.2d 341. . . .

In our judgment, the net income of the petitioner for the taxable year involved could not have been correctly determined upon the accrual basis, without deducting the commission expense from gross income. The method adopted clearly reflected the taxpayer's true income (*American National Company v. United States,* 274 U.S. 99), upon scientific accounting principles (*United States v. Anderson,* 269 U.S. 422, 440).

The items of commission expense claimed as deductible under Section 23 of the Revenue Act were not contingent liability but were definitely incurred and fixed liabilities within the taxable year. The decision of the Board of Tax Appeals is reversed upon mandate that the deduction from petitioner's gross income for 1936 be allowed as prayed in the petition.[1]

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[1] See, generally, Holland, "Accrual Problem in Tax Accounting," 48 Mich.L. Rev. 149 (1949).

Notes

(A) What is the test that shows when an item has accrued? In *United States v. Anderson,* 269 U.S. 422 (1926), the taxpayer was engaged in the manufacture of munitions in 1916. The munitions tax on the profits from 1916 sales became due and was paid in 1917. The taxpayer deducted this amount from its 1917 income. The Supreme Court held that the taxpayer's books were kept on the accrual basis, and that the tax was deductible in 1916, and not in 1917. The Court said (p. 441): "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due, but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued."

For a general discussion see "Accrual: The Uncertain Concept of Certainty—A History of the All Events Test," 21 U. of Chi.L. Rev. 293 (1954). See also Costigan, "Accrual Accounting in the Courts of Appeals," 33 Taxes 339 (1960).

(B) In *Spring City Foundry Co. v. Commissioner,* 292 U.S. 182 (1934), cited in the principal case, the taxpayer had shipped goods during the year 1920. It did not receive payment, and before the close of the year the purchaser became bankrupt. Several years later the taxpayer received a dividend on its claim from the trustee in bankruptcy of the purchaser. The Court held that the entire amount of the sales price was accrued income in 1920. In the law applicable to that year there was no provision (as there is now, in sec. 166(a) (2) of the 1954 Code) for the deduction of a partially worthless debt. As the claim still had some value no adjustment could be made with respect to it during 1920.

(C) In *Fawcus Machine Co. v. United States,* 282 U.S. 375 (1931), the question was the year in which the income tax for 1918 accrued, for the purpose of determining the taxpayer's invested capital at the beginning of 1919. The Revenue Act of 1918, which finally determined the amount of the income tax for 1918, was not enacted until February 24, 1919. The Court held that the tax liability accrued in (or for) 1918. It said: "A corporation cannot claim to have accumulated any net income in any year until provision is made for taxes accrued, based on net income for the same year. . . . The taxes in question were provided for by an act passed in February, 1919, but they were for the year 1918. The act was passed in ample time to allow the taxpayer to readjust its accounts for that year by including these taxes; and, since its books were kept on an accrual basis, it was necessary that this should be done in order clearly to reflect the income for 1918." [1]

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[1] A similar ruling was made in G.C.M. 22366, 1941–1 Cum.Bull. 210, with respect to a retroactive change in the capital stock tax rate. See also G.C.M. 22404, 1940–2 Cum.Bull. 204.

(D) When does income accrue from a sale of goods? Is it at the time the order is given, or accepted, or when the goods are billed, or shipped, or at some other time? In *Pacific Grape Products, Inc. v. Commissioner*, 219 F.2d 862 (C.A.9th, 1955), the taxpayer contracted to sell goods, and billed them to its customers, in accordance with established practice, although shipping instructions had not been received. No specific goods were set aside to meet the order. When shipping instructions were received, the taxpayer took goods out of its general warehouse, and shipped them. It had long followed the practice of including the income in its returns at the time of billing. The court held that the income accrued on billing, despite the fact that no title passed until the goods were set aside and shipped. It also allowed the deduction of an accrual for shipping expenses and brokerage fees.

DIXIE PINE PRODUCTS CO. v. COMMISSIONER

Supreme Court of the United States, 1944. 320 U.S. 516.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The question presented concerns the propriety of the respondent's disallowance of a deduction from income which petitioner took in its federal income tax return for 1937.

In 1936 the Mississippi taxing authorities declared that a solvent used by petitioner in its business was gasoline within the meaning of a state law defining gasoline and laying a tax upon its receipt and use. Accordingly a tax was assessed against the petitioner with respect to the receipt and use of the solvent in 1936. Petitioner paid the tax, and, in the same year, brought suit against the Motor Vehicle Commissioner of Mississippi alleging that the solvent was not within the comprehension of the state law and that the Commissioner should be temporarily and permanently enjoined from future collections of tax in respect of it. The Commissioner's demurrer to the complaint was sustained but, on appeal, the Supreme Court of Mississippi decided that, on the pleadings, the solvent was not within the definition of gasoline contained in the state statute. After this decision petitioner denied that it owed, and ceased and refused to pay, any gasoline tax on solvent used by it.

In December 1937, on advice of counsel, petitioner (which kept its books and filed its federal income tax returns on the accrual basis) made book entries accruing gasoline tax assessed by the Motor Vehicle Commissioner in 1937. The actual accrual entries were made sometime between January 1 and March 15, 1938, as of December 31, 1937, in the amount of approximately $21,000, and petitioner deducted this amount from income in making its 1937 federal income tax return, although the sum had not been, and never was, paid.

In December 1938 petitioner and the Attorney General of Mississippi filed an agreed statement of facts in the state court suit, and, in the same month, the trial judge entered a final decree perpetually enjoining the Motor Vehicle Commissioner from assessing gasoline tax on the solvent used by petitioner. This decree was subsequently affirmed by the Supreme Court of Mississippi. In its 1938 federal income tax return petitioner, by way of compensating entry, included the sum of $21,000 as income and as a recovery, in view of the Mississippi trial court's decree of December 1938.

The sole question is whether the Commissioner was right in disallowing the deduction for the tax year 1937. The Board of Tax Appeals held that he was, and the court below affirmed its decision. We took the case because of a conceded conflict in principle with decisions in other circuits.

Section 23(c) of the Revenue Act of 1936 permits the deduction from gross income of taxes "paid or accrued within the taxable year". Sections 41, 42, and 43 make provision for tax accounting on the accrual basis, where the taxpayer keeps his books on that principle, provided his method clearly reflects his income in any taxable year.

The provisions of the Revenue Act of 1936 worked no significant change over earlier Acts respecting the permissible basis of calculating annual taxable income. The applicable principles of accounting on the accrual basis had been adduced and applied by the Board of Tax Appeals in numerous decisions. It has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year. It has long been held that, in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid; and this cannot be the case where the liability is contingent and is contested by the taxpayer. Here the taxpayer was strenuously contesting liability in the courts and, at the same time, deducting the amount of the tax, on the theory that the state's exaction constituted a fixed and certain liability. This it could not do. It must, in the circumstances, await the event of the state court litigation and might claim a deduction only for the taxable year in which its liability for the tax was finally adjudicated.[1]

To this effect are the decisions of the Board of Tax Appeals in numerous cases, and the instant decision was in line with earlier rulings as to proper tax accounting practice. Since the Board applied the correct rule of law, its determination that the

1 Cf. Brown v. Helvering, 291 U.S. 193.

item in question was not properly deducted on the accrual basis is entitled to the finality indicated by *Dobson v. Helvering,* 320 U.S. 489. The court below properly refused to disturb the Board's determination.

Affirmed.

Notes

(A) See also *Security Flour Mills Co. v. Commissioner,* 321 U.S. 281 (1944), where the taxpayer in the latter part of 1935 accrued on its books processing taxes which it did not pay, and liability for which it resisted. Early in 1936, the tax was held unconstitutional. Thereafter the taxpayer made refunds to some of its customers for the amount of the tax which it had included in the price of goods sold. The Court held that no deduction was allowable for 1935.[2]

(B) Sec. 462 of the 1954 Code, as first enacted, allowing the deduction of a reserve for estimated expenses, might have been useful in connection with disputed taxes. This opportunity is gone for the time being, however, with the repeal of sec. 462 as of the time of its enactment. See page 497, below.

REVENUE RULING 57–105

Internal Revenue Service, 1957. 1957–1 Cum.Bull. 193.

The Internal Revenue Service has been requested to state its position respecting the time for accrual for Federal income tax purposes of additional State income taxes asserted against a taxpayer for prior years.

The general rule applicable to taxpayers who keep their accounts and file their returns on the accrual method is that expenses should be accrued and deducted in the year in which the liability therefor is incurred. The courts have continuously expressed the view that all events must occur to fix a liability of the obligor before an obligation can be recognized by accrual on a taxpayers' books of account. *United States v. Chauncey Anderson et al.,* 269 U.S. 422, T.D. 3839, C.B.V–1, 179 (1926).

Thus, an obligation is considered contingent when the existence of any liability at all is uncertain or when its existence depends upon the happening of a future contingent event. When a taxpayer disagrees with the determination of an additional tax liability, he is in effect disputing or contesting the existence of such additional liability. Therefore, until the contingency disappears and the fact of the additional liability becomes fixed and certain, there can be no accrual for tax purposes of the additional liability.

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2 See Edelmann, "Time for Accrual and Deduction of Taxes," 23 Taxes 110 (1945); Boughner, "Accounting for Items in Dispute," 30 Taxes 1038 (1952).

In G.C.M. 25298, C.B. 1947–2, 39, the term "contest" was held to include a contest lodged with the tax authorities as well as a contest in court. Therefore, unpaid amounts asserted against a taxpayer as additional tax liabilities, which amounts are the subject of a bona fide contest, are not accruable items for Federal income tax purposes while they are unsettled as to amount and prior to establishment of the fact of liability.

A "contest" arises any time there is a dispute as to the proper evaluation of the facts necessary to determine the correct tax liability. The soundness of this position is supported by the holding in the case of *Great Island Holding Corp. v. Commissioner,* 5 T.C. 150, cited with approval in *Gunderson Bros. Engineering Corp. v. Commissioner,* 16 T.C. 118.

The rationale of *Gunderson Bros. Engineering Corp., supra,* is that where a taxpayer files with the State taxing authorities a return reflecting only x dollars tax liability, the taxpayer is in effect denying any greater tax liability. At such time as the taxpayer properly recognizes or concedes a liability to the State for taxes in a greater amount than x dollars, the taxpayer is entitled to an accrual for the additional amount. Thus, an agreement between the taxpayer and the Internal Revenue Service with respect to the taxpayer's income for Federal income tax purposes is not necessarily determinative of the taxpayer's income for State tax purposes. It follows that a taxpayer is not entitled to accrue as additional tax liability an amount of State tax until the fact of liability is established and the amount thereof is settled.

Accordingly, in the case of an accrual method taxpayer, an increase in the amount of the State tax accrues and is allowable as a deduction for Federal income tax purposes when the amount is finally determined by litigation or default, or when the taxpayer acknowledges his liability to the State for the amount of such increase.

Pursuant to the authority granted by section 7805(b) of the Internal Revenue Code of 1954, the tax liability for taxable years ended prior to May 1, 1957, shall not be adjusted to apply this Revenue Ruling unless such adjustment is requested by the taxpayer in a timely claim for refund.

Notes

(A) What is the significance of this ruling? What does it add to the *Dixie Pine* decision? Why was the *Dixie Pine* case not cited?

Is the ruling applicable to a situation where the taxpayer pays the tax, but then seeks to get it back, as by filing a claim for refund, and litigating the question in the courts?

See "Accrual of Tax Deficiencies and Recoveries," 58 Col.L. Rev. 372 (1958).

(B) In *Consolidated Edison Co. v. United States,* 279 F.2d 152 (C.A.2d, 1960), the state taxes were for the year 1948. Additional taxes were claimed and these were paid under protest in 1949. Contest was continued in the state courts, and in 1951 the state's claim was settled for a smaller amount than had been paid. The excess was refunded in 1951. The court held that the disputed tax did not accrue until 1951, though paid in 1949, and that no income was derived from the refund in 1951.

This result is in conflict with the decision involving the same taxpayer in *Consolidated Edison Co. v. United States,* 133 Ct.Cls. 376, 135 F.Supp. 881 (1955), cert. den. 351 U.S. 909 (1956).

Commissioner v. Hansen, 360 U.S. 446 (1959), involved automobile dealers, keeping their books on the accrual basis. They followed a common practice of selling cars, receiving a trade in, down payment, and a negotiable instrument—the transaction being secured by a conditional sale or chattel mortgage agreement. The dealer then discounts the instrument with a finance company. The finance company pays the dealer a major percentage of the purchase price, but they retain a portion of the amount, crediting it to a "Dealers' Reserve Account," in the name of the particular dealer. This is retained for the purpose of securing the payment of the purchase price to the finance company by the purchaser of the automobile. The amount in this "Dealers Reserve Account" will be paid to the dealer eventually, after all of the payments have been made by the purchasers.

The dealers included in their income the cash received from the finance companies, "but they did not accrue on their books or include in their returns the percentage of the price that was retained by the finance companies and credited to their reserve accounts." The Supreme Court held that the amounts credited to the reserve accounts were accrued income to the dealers at the time of the credit, and were taxable at that time.

In The Dealer Reserve Income Adjustment Act of 1960, approved May 12, 1960, Congress provided means to spread the tax resulting from this decision over a period of years, at the election of the dealer.

Notes

Reserves—and Accrual of Future Expenses

(A) In *Brown v. Helvering,* 291 U.S. 193 (1934), the taxpayer was a general agent for fire insurance companies, and was entitled to receive overriding commissions on policies written by local agents. Many of these policies ran for more than one year; where such a policy is cancelled, the policyholder is entitled to

the return of a portion of his premium. In such a case, the taxpayer was required to return to the company the corresponding portion of the commission he had received. The taxpayer's books were kept on the accrual basis, and he set up in his books a liability account called "Return Commission." In it was recorded an estimate, based on experience, of the liability to refund commissions with respect to policies written during the taxable year. In making his tax returns, the taxpayer deducted the amount shown in this account. The Commissioner disallowed this, and the Supreme Court sustained the Commissioner. It said (pp. 201–202): "Only a few reserves voluntarily established as a matter of conservative accounting are authorized by the Revenue Acts. . . . Many reserves set up by prudent business men are not allowable as deductions."

Which method of accounting more accurately reflected the taxpayer's income?

(B) A paving company, on the accrual basis, completes a job and receives payment. Under its contract, however, it is obligated to maintain the pavement for a period of years, and it sets aside a portion of what it receives as a reserve to cover this cost of maintenance. Is the amount reserved taxable in the year of receipt? *Union Paving Co.*, 6 B.T.A. 527 (1926). *Cf. Commissioner v. Cleveland Trinidad Paving Co.*, 62 F.2d 85 (C.C.A.6th, 1932), where the city withheld ten per cent of the contract price to insure performance of the obligation to repair.[1]

HARROLD v. COMMISSIONER

United States Court of Appeals, Fourth Circuit, 1951. 192 F.2d 1002.

SOPER, CIRCUIT JUDGE. These are petitions to review orders of the Tax Court involving income tax for the year 1945, upholding the Commissioner of Internal Revenue's disallowance of a deduction of $25,210.18, and asserting a deficiency against taxpayer Harrold in the amount of $12,935.95 and taxpayer Cromling in the amount of $11,458.04.

During the taxable year and prior thereto, the taxpayers were partners doing business under the firm name of Cromling & Harrold and were engaged in the mining of bituminous coal from leased lands by the strip mining method. This is a process whereby the soil or overburden is removed so that the coal can be mined with shovels. The partnership kept its books and filed its federal income tax returns on the accrual basis.

In 1945 the partnership removed coal by the strip mining method from 31.09 acres of land in West Virginia held by it under five leases and contracts which required it to conduct the mining operations in conformity with the laws of West Virginia and of the United States, and to restore and replace the surface in

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1 For consideration of similar questions under the pre-1954 law, see Reiling, "Tax Accounting for Repricing and Other Reserves," 31 Taxes 990 (1953); Bruton, "Reserves and Deposits," 31 Taxes 697 (1953).

compliance with provisions of pertinent laws of West Virginia. Before starting mining operations on the leased lands, the partnership obtained strip mining permits as required by the laws of West Virginia, and posted penal bonds with the state to insure faithful performance of its statutory obligation to refill the lands. The contractual and statutory obligation on the partnership to "backfill" required it to put the soil back the way both the state and the lessor farmers wanted it. It was necessary to fertilize and replant the land with grass, shrubs or clover before the Department of Mines of West Virginia would release the bonds.

At the end of 1945 the tract of 31.09 acres had been completely stripped and the coal had been removed; and the obligation of the partners to refill had become fixed and definite. Paul Harrold, one of the partners, had been actively engaged in strip mining and back-filling lands in West Virginia for sixteen years. Based on this experience the firm estimated in 1945 that the cost of the refill in this instance would amount to $1,000 per acre; but since the firm was using its equipment in stripping operations elsewhere it postponed the refilling until 1946, and in accord with sound accounting practice set up a reserve on its books for the accrued expense involved in the sum of $31,090 and deducted the same as an expense of the business in its federal income tax for 1945.

The process of back-filling was commenced in the spring of 1946, when the weather became favorable, and was completed during 1946 at a cost of $25,210.18 or $5,879.82 less than estimated and accrued. Accordingly the partnership reduced the 1945 accrual on its books, and, on January 6, 1947, filed an amended partnership return for the taxable year 1945, reducing the estimated deduction to the actual cost of back-filling the land.

The Tax Court, conceding that it was the practice of prudent business men to set up reserves to cover contingent liabilities, nevertheless held that deduction from income in 1945 could not be allowed because the liability which it represented was not fixed and certain, but was based merely on an estimate of the future cost of the work. In support of this conclusion it pointed out that the cardinal rule in the federal income tax system is that net income must be computed and taxed on an annual basis so as to provide revenue to the government at regular intervals; and hence neither income nor deduction may be accelerated or postponed from one taxable year to another in order to reflect the ultimate result of a business transaction; and this principle must be observed, even though the allocation of an indefinite obligation to the taxable year in a given instance would seemingly work a more equitable result to the government or the taxpayer. Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363; Brown v. Helvering, 291 U.S. 193.

Accordingly it is established that deductions may be taken on an accrual basis only in the year in which the taxpayer's liability to pay has become fixed and certain; and in some decisions, notably Security Flour Mills Co. v. Com'r, 321 U.S. 281, 286–287, and Dixie Pine Products Co. v. Com'r, 320 U.S. 516, 519, it has been said that unless the amount as well as the fact of liability has become final and definite in the year in which the accrual is claimed, the deduction must be allowed only in the year in which the payment actually takes place. It is true that in these cases the court was concerned with the existence rather than the amount of the liability; but in other decisions uncertainty of the amount alone has been held enough to bar the accrual of the expense in the year in which the liability therefor has become established. Thus in Spencer, White & Prentis v. Com'r, 2 Cir., 144 F.2d 45, a contractor, under an obligation to restore certain structures in the streets of New York which had been disturbed or destroyed in the construction of a subway, was not allowed to accrue the estimated cost of restoration in a tax year prior to the doing of the work; and in Capital Warehouse Co. v. Com'r, 8 Cir., 171 F.2d 395, a warehouseman, who collected from customers upon the receipt of goods for storage, a charge for the removal of the goods subsequently to take place, was not allowed to accrue in advance the cost of the removal operation based on the experience of other warehousemen, that 60 per cent of the cost should be allocated to the expense of handling out and 40 per cent to the expense of handling in, owing to the fact that merchandise usually came into the warehouses in carload lots and left in less than carload lots. The experience of the taxpayer, however, differed in that in its case the merchandise was shipped out in carload lots.

There is no material distinction between Spencer, White & Prentis v. Com'r, supra, and the pending case unless it be that in the former an approximate estimate of the cost of the work of restoration, considering the number and unusual character of the items involved, could not be easily arrived at before the work was undertaken. In any event, we think that the ability to make an approximate estimate should be the determining factor in each case, rather than the literal application of the formula that an asset or a liability may not be accrued in any taxable year prior to its liquidation, unless both existence and the amount thereof is fixed and certain.

As to the need for the existence of a definite asset or liability to justify an accrual in the taxable year, there can be no doubt as many decisions attest; Lucas v. American Code Co., 280 U.S. 445; Burnet v. Sanford & Brooks Co., 282 U.S. 359; but it has not been deemed essential that the amount of an accrued liability shall have been definitely ascertained to justify deduction from

income in the taxable year. Confessedly, it is enough if the facts from which the amount can be calculated had then occurred and are later ascertained, or as Judge Learned Hand puts it in Uncasville Mfg. Co. v. Com'r, 2 Cir., 55 F.2d 893, 895, if the computation, although unknown, is not unknowable at the end of the year. Such was the situation before the court in Continental Tie & Lumber Co. v. United States, 286 U.S. 290, where the amount of a government award was not ascertained until 1923, but it was held that the right of the taxpayer thereto having ripened in 1920, it should have been returned in an estimated amount as part of the income for that year. To the same effect was the decision of this court in Baltimore & Ohio R. Co. v. Com'r, 4 Cir., 78 F.2d 456.

Again it has been held that a liability may be accrued as a fixed obligation on the taxpayer's books and taken as a deduction from income when it is definitely incurred, although it is known at the time that the amount may be diminished by subsequent events. American National Co. v. United States, 274 U.S. 99; Ohmer Register Co. v. Com'r, 6 Cir., 131 F.2d 682.

It is not suggested that the pending case falls precisely within either of the two categories last described. They serve to show, however, that the accrual of the approximate amount of an item that comes into existence in a taxable year to be followed by appropriate adjustments when the precise amount is ascertained, is not deemed impracticable by the taxing authorities or inconsistent with the principle that income and outgo must be computed and taxed on an annual basis. Moreover, decisions of the courts, including the Tax Court itself, furnish examples of the allowance of a reasonably accurate estimate of the cost of meeting a liability as a proper deduction from income of a taxpayer on the accrual basis, even when the work is not done and the precise cost is therefore, not ascertainable until after the expiration of the fiscal year. The matter is discussed and clarified by Justice Brandeis in Lucas v. American Code Co., 280 U.S. 445, where he held that a corporation, which had broken a contract with a sales manager employed on a commission basis, could not accrue its liability on its books pending the termination of a suit for damages for breach of the contract. He said, 280 U.S. at pages 449–450:

"Generally speaking, the income tax law is concerned only with realized losses, as with realized gains. Weiss v. Wiener, 279 U.S. 333, 335. Exception is made, however, in the case of losses which are so reasonably certain in fact and ascertainable in amount as to justify their deduction, in certain circumstances, before they are absolutely realized. As respects losses occasioned by the taxpayer's breach of contract, no definite legal test is provided by the statute for the determination of the year in which the loss is to

be deducted. The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal, test." * * *

"* * * The Board of Tax Appeals has held, in a series of well-reasoned opinions, that a loss occasioned by the taxpayer's breach of contract is not deductible in the year of the breach, except under the special circumstances where, within the tax year, there is a definite admission of liability, negotiations for settlement are begun, and a reasonable estimate of the amount of the loss is accrued on the books." . . .

We conclude that when all the facts have occurred which determine that the taxpayer has incurred a liability in the tax year, and neither the fact nor the amount of the liability is contested, and the amount, although not definitely ascertained, is susceptible of estimate with reasonable accuracy in the tax year, deduction thereof from income may be taken by a taxpayer on an accrual basis. This procedure does not violate the principle that income taxes must be calculated on an annual basis, but, on the contrary, allocates to each year the proper income and expense, and prevents distortion of the taxpayer's financial condition in the tax year. See United States v. Anderson, 269 U.S. 422, 440. It gives heed to the true facts of each case rather than to an arbitrary rule of thumb; and the adjustments which must be made after the precise amount is ascertained are as easily consummated as those which are required when it is impracticable to make precise calculations of income or outgo before the end of the year, although all of the events which fix the amount have accrued therein. We think the proper approach to the problem before us should be realistic and one that accords with good business practice, rather than an approach based upon subtle technicalities.

The decision of the Tax Court is reversed and the case remanded for further proceedings in accordance with this opinion.

Reversed and remanded.

Notes

(A) The *Harrold* case was distinguished in *Patsch v. Commissioner,* 208 F.2d 532 (C.A.3d, 1953), on the ground that in the *Patsch* case the amount of liability was not clear, and the taxpayer did not proceed promptly to carry out the backfill.

But see *Schuessler v. Commissioner,* 230 F.2d 722 (C.A.5th, 1956), which allows the deduction of an estimate for the expenses of servicing furnaces over a period of five years after the date of sale.

AUTOMOBILE CLUB OF MICHIGAN v. COMMISSIONER

Supreme Court of the United States, 1957. 353 U.S. 180.

MR. JUSTICE BRENNAN delivered the opinion of the Court.

[The case involves income tax liability for 1943, 1944, and 1945. In the first portion of the opinion, omitted here, the Court held that the deficiency determined by the Commissioner was not barred by the Statute of Limitations. This portion of the opinion is summarized at pages 98–99, above.]

The final issue argued concerns the treatment of membership dues and arises because such dues are paid in advance for one year. The dues upon collection are deposited in a general bank account and are not segregated from general funds but are available and are used for general corporate purposes. For bookkeeping purposes, however, the dues upon receipt are credited to an account carried as a liability account and designated "Unearned Membership Dues." During the first month of membership and each of the following eleven months one twelfth of the amount paid is credited to an account designated "Membership Income." This method of accounting was followed by petitioner from 1934. The income from such dues reported by petitioner in each of its tax returns for 1943 through 1947 was the amount credited in the year to the "Membership Income" account. The Commissioner determined that the petitioner received the prepaid dues under a claim of right, without restriction as to their disposition, and therefore the entire amount received in each year should be reported as income. The Commissioner relies upon *North American Oil Co. v. Burnet,* 286 U.S. 417, 424, where this Court said: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, . . . [it] has received income which . . . [it] is required to return . . . ."

The petitioner does not deny that it has the unrestricted use of the dues income in the year of receipt, but contends that its accrual method of accounting clearly reflects its income, and that the Commissioner is therefore bound to accept its method of reporting membership dues. We do not agree. Section 41 of the Internal Revenue Code of 1939 required that "[t]he net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books . . . but . . . if the method employed does not clearly reflect the income the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . ." The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in

fact be called upon to render for the member.[20] Section 41 vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits. See *Brown v. Helvering,* 291 U.S. 193, 204–205.

Affirmed.

MR. JUSTICE HARLAN, dissenting. . . .

I also disagree with the Court's holding that the Commissioner may properly tax in the year of receipt the full amount of petitioner's prepaid membership dues. The Commissioner seeks to justify that course under the "claim of right" doctrine announced in *North American Oil Co. v. Burnet,* 286 U.S. 417. However, that doctrine, it seems to me, comes into play only in determining whether the treatment of an item of income should be influenced by the fact that the right to receive or keep it is in dispute; it does not relate to the entirely different question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting. See *Brown v. Helvering,* 291 U.S. 193, where these two problems were involved and were treated as distinct. The collection of taxes clearly should not be made to depend on the vicissitudes of litigation with third parties in which the taxpayer may be engaged. That is quite a different thing, however, from holding that the Commissioner may force taxpayers to abandon reasonable and accurate methods of accounting simply because they do not reflect advance receipts as income in the year received. Under § 41 of the Internal Revenue Code of 1939, the income of the taxpayer is to be determined "in accordance with the method of accounting regularly employed in keeping the [taxpayer's] books," unless "the method employed does not clearly reflect" the taxpayer's income. Under § 42, items of gross income need not be reported in the taxable year in which received by the taxpayer if, "under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period." And it is clear that accrual methods of accounting may be employed. *United States v. Anderson,* 269 U.S.

20 Beacon Publishing Co. v. Commissioner, 218 F.2d 697, and Schuessler v. Commissioner, 230 F.2d 722, are distinguishable on their facts. In Beacon, performance of the subscription, in most instances, was, in part, necessarily deferred until the publication dates after the tax year. In Schuessler, performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year. In this case, substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year. We express no opinion upon the correctness of the decisions in Beacon or Schuessler.

422. The Commissioner's own regulations authorize the deferral of income in some instances.[6]

The Court, however, now by-passes the Commissioner's "claim of right" argument, and rests its decision instead on the ground that the "pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member," so that it cannot say that in doing what he did the Commissioner exceeded the limits of his discretion. I do not understand this, because the Commissioner does not deny—as, indeed, he could not—that the method of accounting used by the taxpayer reflects its net earnings with considerably greater accuracy than the method he proposes. Nor does he urge that the taxpayer's accounting system defers income in a manner or to an extent that would make the Government unreasonably dependent on the continued solvency of the taxpayer's business. And no other circumstances have been shown which would justify application of the statutory exception.

On both of these grounds I would reverse the judgment below.

[MR. JUSTICE BURTON and MR. JUSTICE CLARK concurred in this portion of MR. JUSTICE HARLAN'S dissent].

Notes

(A) Although the tax rule that income is taxable at least as soon as it is actually received is clearly stated, as the *Automobile Club* case shows, there is some tendency in the courts to find ways to avoid taxing all of the income on receipt in such cases. Thus, in *Beacon Publishing Co. v. Commissioner,* 218 F.2d 697 (C.A.10th, 1955), the taxpayer was allowed to treat prepaid magazine subscriptions received in 1943 and 1944 as income only as they were earned, even though it had included subscriptions as income when received in previous years.

(B) In *Bayshore Gardens, Inc. v. Commissioner,* 267 F.2d 55 (C.A.2d, 1959), the court dealt with a premium paid, in cash, by a mortgagee to a mortgagor in connection with a loan for a building project. It was held that the mortgagor, who received the premium, could amortize it, including it in income ratably over the life of the loan. The *Automobile Club* case was distinguished on the ground that there the exact expenditures were not foreseeable, while here the allocation of the premium over the period was precise. Is this satisfactory?

The court was also influenced by the analogy with the provisions long in the regulations, to which reference is made below (see p. 524) allowing the amortization of premium received on the issue of corporate bonds. On this basis, the Treasury has

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[6] Regulations 111, §§ 29.22(a)–17(2)(a) (bond premiums), 29.42–4 (long-term contracts). See also I.T. 3369, 1940–1 Cum.Bull. 46 (prepaid subscriptions to periodicals); I.T. 2080, III–2 Cum.Bull. 48 (1924) (advance receipts from sales of tickets for tourist cruises).

announced that it will follow the *Bayshore Gardens* case. Rev. Rul. 59–422, 1959–2 Cum.Bull. 451.

(C) Similarly, in *Bressner Radio, Inc. v. Commissioner,* 267 F.2d 520 (C.A.2d, 1959), where the taxpayer sold 12-month television servicing contracts for a lump sum, the court held that it could follow its long-continued method of accounting, and include the payments in income over the 12-month period in accordance with its experience. The *Automobile Club* case was distinguished on the ground that here the Commissioner was not able to prove that the deferral of income did not clearly reflect income.

The Treasury has announced that it will not follow the *Bressner Radio* case. Rev.Rul. 60–85, 1960–1 Cum.Bull. ——. For comment on the *Bressner Radio* case, see 1960 Duke L.J. 127.

(D) The *Automobile Club* case was followed in *American Automobile Ass'n v. United States,* 181 F.Supp. 255 (Ct.Cls.1960), and in *Automobile Club of Southern Calif. v. United States,* —— F.Supp. —— (S.D.Calif.1960).

Thus the area is left in some uncertainty!

Sec. 452 of the 1954 Code—and Its Repeal

When Congress adopted the Internal Revenue Code of 1954, this question was materially affected by sec. 452, which dealt expressly with "Prepaid income," and provided for spreading the tax liability over a period of years. The Senate Committee Report with respect to this provision contained the following passage (Senate Report No. 1622, 83rd Congress, 2nd Session, p. 301):

"Under the 1939 Code, regardless of the method of accounting, with minor exceptions established by regulations or administrative practice, amounts are includible in gross income by the recipient not later than the time of receipt if they are subject to free and unrestricted use by the taxpayer even though the payments are for goods or services to be provided by the taxpayer at a future time. Section 452 will permit the taxpayer to defer the inclusion in income of these amounts until earned in the manner required by the taxpayer's method of accounting subject to the rules and conditions prescribed in the section."

Although the objective of this provision seems desirable, the Treasury became badly worried when tax return time came in early 1955. The Treasury had estimated that this provision and the related one in sec. 462 relating to reserves for estimated expenses would cost about $47 million in revenue. It became apparent, however, that the provisions were too loosely drawn, and that the actual revenue loss would be much higher, some estimates running up to several billion dollars from the two provisions. Accordingly, the Treasury requested repeal of secs. 452

and 462, and after considerable discussion and delay, this was done by the Act of June 15, 1955. The Treasury stated that it was still concerned about the problem, and would seek to develop a provision which would achieve the desired result without the great revenue loss which was feared from the provisions as originally enacted in 1954.

How should a section be drafted to deal with appropriate cases of prepaid income?

For consideration of the problems arising out of the repeal, see Wagman, "Sections 452 and 462: Stormy Past But a Bright Tomorrow," 33 Taxes 711 (1955); Sporrer, "The Past and Future of Deferring Income and Reserving for Expenses," 34 Taxes 45 (1956); "Taxation of Prepaid Income: A Temporary Solution," 67 Yale L.J. 1425 (1958); Behren, "Prepaid Income-Accounting Concepts and the Tax Law," 15 Tax L.Rev. 343 (1960).

Sec. 462 of the 1954 Code—and Its Repeal

When the 1954 Code was enacted, it contained in sec. 462 a provision allowing the deduction of "a reasonable addition to each reserve for estimated expenses to which this section applies." This was a very substantial innovation in the law, of importance to a large number of taxpayers.[1] It was available only to taxpayers who made their returns on the accrual basis. Sec. 462(c)(1).

Unfortunately, the provision was not cautiously drafted. It was provided that the allowance of the addition to the reserve should be "in the discretion of the Secretary or his delegate." But this apparently did not limit the types of future expenses to which the section might be applied; and taxpayers and their advisers sought to exploit the provision by establishing reserves for every conceivable sort of future expenditure. The Treasury estimated in 1955 that the loss of revenue from this provision would be several billion dollars, although the original estimate for this section and sec. 452 combined had been $47 million at the time the Internal Revenue Code of 1954 was before Congress. The American Institute of Accountants estimated (after the returns for 1954 were prepared) that the loss of revenue was about $500 million. See 99 J. of Accountancy 9, 35 (May, 1955). But this was probably on the low side.

The difficulties with the provision were chiefly two: (1) The lack of any sort of limitation on the sort of expenditures covered, and (2) The allowance of what amounted to a double deduction

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[1] See Bierman and Helstein, "Accounting for Prepaid Income and Estimated Expenses under the Internal Revenue Code of 1954," 10 Tax L.Rev. 83 (1954).

for the year 1954. On the first of these points, there was, as might have been expected, no limit to the fertility of the taxpayers and their advisers as to the sort of expenses that could be brought within the new provision. Not only were such situations as those in *Brown v. Helvering* and the *Harrold* case covered, but deductions were taken for reserves for future repairs, for vacation and severance pay, and many other matters. The double deduction resulted from the fact that taxpayers were allowed to deduct for 1954 their actual expenses for that year and also the initial payment to a reserve for future expenses.[2] This seems difficult to justify. It would seem that if a change to a reserve basis is to be allowed, taxpayers should be required to elect between one method or the other. Thus, they could continue to deduct their actual expenses, or they could deduct an addition to a reserve for future expenses, but not both.

The Treasury became much alarmed at the loss of Revenue involved, and early in 1955 asked Congress to repeal sec. 462 (and also the related provision in sec. 452; see p. 496, above). This was done by the Act of June 15, 1955. Thus we are back where we started on this matter.

Is it possible to draft a provision designed to carry out the objective of sec. 462 without opening the door as wide as was done by that provision? Could this be done by specifying certain sorts of reserves which would be recognized for this purpose? [3]

See Wagman, "Sections 452 and 462: Stormy Past But a Bright Tomorrow," 33 Taxes 711 (1955); Sporrer, "The Past and Future of Deferring Income and Reserving for Expenses," 34 Taxes 45 (1956); Wolder, "Deduction of Reserves for Future Expenses and Deferring of Prepaid Income," 34 Taxes 524 (1956).

Problems

(A) Employees of a railroad performed services for which they were entitled to wages. The company accrued the wages on its books and deducted them in its income tax return. If the wages were not claimed after two years, the railroad, according to the accounting practice established by the Interstate Commerce Commission, credited them to profit and loss. Does the company have income in the year of credit? *Chicago, R. I. & P. Ry. v. Commissioner,* 47 F.2d 990 (C.C.A.7th, 1931), cert. den. 284 U.S. 618 (1931). See also *Fidelity-Philadelphia Trust Co.,* 23 T.C. 527 (1954), where a bank transferred unclaimed deposits to surplus.

(B) The taxpayer owned an iron mine. She leased it. The lessee agreed to pay a royalty of 40 cents a ton, and guaranteed

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[2] See Kronemyer, "The Vacation Pay Controversy and Double Deductions under the 1954 Code," 32 Taxes 884 (1954).

[3] In addition to the back fill, and paving, questions, consider the following: cash discounts, bottle return allowance, trading stamps, freight discounts, returns by customers, quantity discounts, repairs and services, vacation pay, workmen's compensation claims.

a minimum royalty of $20,000 per year. The lessee paid the minimum royalties each year, but it removed no ore at all, and at the end of the eight year term, it surrendered the lease. In each of the years when she received royalties, the taxpayer took a deduction for depletion, under the provision which is now found in sec. 613 of the 1954 Code. In the year in which the lease terminated, without any ore having actually been mined, the Commissioner required that the amounts previously deducted as depletion be included as income. See sec. 39.23(m)–10(c) of Regulations 118. This contention was sustained in *Douglas v. Commissioner,* 322 U.S. 275 (1944).

See also Rev.Rul. 54–566, 1954–2 Cum.Bull. 96, where a gift was made in 1951 to a charity, and the donor took a deduction. In 1953, at the donor's request, the charity transferred the gift to a Fund which was not tax-exempt. It was ruled that this produced income to the donor.

The "Tax Benefit" Problem

In the cases just put, would it make any difference that the taxpayer derived no "tax benefit" from the deduction in the earlier year, because he had no net income, and thus no tax liability, even apart from the deduction in question? This question may arise with respect to recoveries or eventual non-payment of a good many different sorts of previously deducted items, e. g., taxes which are subsequently found to be invalid or excessive, bad debts, interest, business expenses, recoupment of losses, and other amounts.

The problem is partially dealt with in sec. 111 of the 1954 Code carrying forward a provision which was first added to the tax law in 1942. See also sec. 1.111–1 of the Income Tax Regulations. This applies in terms only to the recovery of bad debts, prior taxes and related payments. In *Dobson v. Commissioner*, 320 U.S. 489 (1943), however, the Supreme Court sustained the decision of the Tax Court applying the "tax benefit" rule to the recovery of a loss. But the Court had previously refused to apply it to depreciation. *Virginian Hotel Corp. v. Helvering*, 319 U.S. 523 (1943). And in the *Douglas* case, cited in the preceding problem, an equally divided Court refused to apply the tax benefit rule to the depletion deduction there involved.

The Treasury provided by regulation that the tax benefit principle should be applied in the case of all recoveries of previously deducted amounts except "depreciation, depletion, amortization, or amortizable bond premiums." See sec. 39.22(b)(12)–1(a) of Regulations 118, as amended by T.D. 5454, 1945 Cum.Bull. 68.[1]

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[1] The general problem is extensively discussed in Plumb, "The Tax Benefit Rule Today," 57 Harv.L.Rev. 129 (1943); Plumb, "The Tax Benefit Rule Tomorrow," 57 Harv.L.Rev. 675 (1944); Tye, "Tax Benefit Developments," 2 Tax L.Rev. 106 (1946); Tye, "The Tax Benefit Doctrine Re-examined," 3 Tax L.Rev. 329 (1948).

See also "The Tax Benefit Rule and the Loss Carry-over Provisions of the 1954 Code," 67 Yale L.J. 1394 (1958).

This is now found in sec. 1.111–1(a) of the Income Tax Regulations.

The exception was, of course, supposed to be required by the decisions in the *Virginian Hotel* and the *Douglas* cases. These cases turned on language previously found in sec. 113 of the 1939 Code (with respect to adjustment of the basis of property) which was not applicable to other sorts of recoveries.

As far as depreciation and depletion are concerned, the *Virginian Hotel* case has now been overruled by statute. This was done by an Act passed in 1952, which added the language now found in sec. 1016(a)(2)(B) of the 1954 Code. Under this, the taxpayer may, at his election, restore excessive depreciation or depletion previously claimed for which no tax benefit was received.

Note

Should there also be a tax detriment theory? Suppose a taxpayer receives an item of income and then has to repay it in a later year. Suppose that no tax resulted in the year of receipt because the taxpayer had no taxable income in that year even after including the item in question in his gross income. Should he be entitled to a deduction in the year of repayment?

Note that the possibility that there will not be a tax benefit from an item of deduction is greatly reduced by the now extensive application of carry-backs and carry-forwards—the net operating loss deduction under sec. 172 of the 1954 Code. Even though the item produces no tax benefit in the year of deduction, there will be a tax benefit if the loss from that year is effectively applied against the income of some other year through a carry-back or carry-over.

PERRY v. UNITED STATES

United States Court of Claims, 1958. 160 F.Supp. 270.

WHITAKER, JUDGE. Plaintiffs, who have filed a joint income tax return for the calendar year 1953, sue to recover taxes paid by them for that year in the amount of $8,287.26, plus interest as provided by law. The issue presented is whether an income tax may be imposed upon the corpus of a charitable trust that has been returned to the sole settlor when the donees thereof have refused to comply with the terms of the gift.

Plaintiff William F. Perry in 1944 created a trust for the benefit of the Town of Fitzwilliam, New Hampshire. The corpus was to be used for the construction of an addition to the Public Library and for no other purpose. The town decided that it did not desire to build the addition to the library, and the corpus of the trust was returned to the settlor in 1953.

The Commissioner of Internal Revenue required plaintiffs to include in their income tax return for 1953 the amount returned

to them in that year. Plaintiffs say this is improper, because what they received was a return of capital, and not income. The defendant says it was proper because plaintiffs, in the years they made contributions to the trust, deducted the amounts contributed from their income, and thus received a tax benefit in those years.

There can be no doubt that what the taxpayer received from the town in 1953 was a return of capital and not income, except for the accumulations of interest and dividends on the corpus. The taxpayer admits he is required to include these accumulations in his income.

The taxpayer does not admit that he is required to account for the appreciation in value of the securities, and we do not think he is. He gave the securities to the town for a specific purpose. When the securities were returned, because the town did not desire them for this purpose, it was as if they had remained in the taxpayer's possession all the time, and, hence, he was not required to account for the appreciation in value until he disposed of them.

As stated, the return to the taxpayer of the property he had tried to give away cannot possibly be considered as income—he merely got back his own property. It cannot possibly be considered as income, except on the ground that he had deducted from his income the amount contributed in each year, thus reducing his taxes. In such cases the courts have heretofore required the inclusion of an item recovered, where a deduction had been taken for it in a prior year.

The only rational basis for such decisions is that it would be inequitable for the taxpayer to reduce his taxes for prior years on account of the contributions, and not to pay taxes on them when he got them back. This is the so-called tax benefit rule. It is a rule enunciated by the courts, and not by Congress, and is based altogether on equitable considerations. But the Supreme Court, in the case of *Lewyt Corp. v. Commissioner,* 349 U.S. 237, 240, had this to say of equitable considerations in the administration of tax law:

> "But the rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall. * * *"

In other words, the Supreme Court said that equitable considerations have no place in the laws of taxation. The tax benefit rule is based upon equitable considerations, and if we are to take the statement in *Lewyt Corp. v. Commissioner, supra,* at its face value, we must hold that the amounts received in 1953 are not to be included in gross income merely because the taxpayer had received a tax benefit on account of them in prior years.

We must say, however, that the tax benefit rule seems well entrenched in judicial decision. The Supreme Court impliedly recognized it in *Dobson v. Commissioner,* 320 U.S. 489, and had done so many times before.

The only Congressional sanction for the tax benefit rule is section 22(b)(12) of the Revenue Act of 1939, as amended, which prohibits the inclusion within income of a subsequent year of all amounts recovered as to which the taxpayer had received no tax benefit as the result of a deduction in a prior year. This was limited, however, to the recovery of bad debts, and taxes and delinquency amounts.

The present case does not come within the provisions of that statute. The Commissioner of Internal Revenue, however, after the enactment of section 22(b)(12) made the section applicable to transactions other than bad debts and taxes. In T.D. 5454 (1945 Cum.Bull. 68) it was provided that tax benefit principles should apply to "other losses, expenditures, and accruals made the basis for deductions."

If, therefore, we should hold that the amounts received in 1953 were not includable in gross income at all, we would be going contrary to prior judicial decisions, and to the express provisions of the Treasury Regulations. Therefore, bowing to the weight of judicial precedents, and in the face of the language in the Lewyt case, supra, we feel compelled to hold that we must take into account the tax benefit received by the taxpayers in prior years.

By this we mean that in computing income for 1953, the taxpayers should exclude from their income the amount of the corpus returned to them in that year, but they should add to the tax thus computed on their 1953 income the amount by which their taxes in prior years had been decreased on account of the deductions made for contributions to this trust fund. So computed, the Government would recoup the taxes escaped in the prior year on account of the deduction. It would be inequitable to require plaintiffs to include in their income for 1953 the aggregate of the deductions claimed in prior years, because of the fact that the rates of taxation vary greatly from year to year, and because the inclusion in one year of all the deductions taken in several years would probably put the taxpayer in a higher tax bracket.

In computing the gain on the stock sold by the settlor shortly after it was returned to him, original cost should be used as a basis.

Plaintiffs are entitled to recover, including interest as provided by law, and judgment is entered to that effect. . . .

It is so ordered.

JONES, CHIEF JUDGE, and LITTLETON, JUDGE, concur.

MADDEN, JUDGE (dissenting). When the plaintiff William F. Perry conveyed the property in question to the town, he inserted a condition that if the property was not used to finance an addition to the library, it should be returned to him. He thus retained an interest in the property, of a highly contingent nature, an interest not at all likely to expand into complete ownership. But his contingent interest did expand into complete ownership.

If one sells a piece of land, and is paid for it, but puts a condition in the deed that if liquor is sold on the premises he is to get the land back, he has a contingent interest comparable to that of the grantor plaintiff in the instant case. If the condition happens and he gets the land back, I suppose there are no immediate income tax consequences. If he later sells it, I suppose his basis would be zero, because he was once paid for the land, and his capital gain or loss was computed at that time.

The factor in the instant case that produces possible tax consequences is that the conveyance subject to the condition subsequent was a conveyance to charity, and therefore was deductible, and was deducted from otherwise taxable income in the year in which the conveyance was made.

The plaintiff urges that the reconveyance from the town to him was a gift, and therefore expressly tax free to him as recipient, under section 22(b)(3) of the Internal Revenue Code of 1939. This would present the unusual situation of a gift *from a charity,* in contrast to the usual one of a gift to a charity. The interest which the plaintiff reserved in the property when he conveyed it to the town was the reason and consideration for the town's reconveyance to him, and the transaction was not a gift.

What we have, then, is the unanticipated recovery by a former owner of property of that property after he has given it up for lost. The plaintiff was in a situation comparable to that of the person who has had to pay taxes and hopes that he may get them back later by litigation, or the one who has given up all real hope of collecting a debt owed to him. In the latter case, the income tax law allows a deduction from income for the taxes paid, and for the bad debt. In these latter situations, if the taxpayer recovered his taxes or collected his bad debt in a later year, the administrative authorities and the courts, without the help of any

statute, required him to pay income tax upon his recovery. Of course, one does not ordinarily acquire taxable income by collecting a debt, or by a refund of taxes which he never should have had to pay. The reason that the money was regarded as taxable in the special cases referred to was that, once having used the taxes paid or the bad debt as a tax deduction, the prospect of recovery was, *for income tax purposes,* written off, though as a legal claim it still existed. Having been written off, the later realization of the claim was, *again for tax purposes,* like a windfall to the taxpayer, and within the broad definition of taxable income. See Commissioner of Internal Revenue v. Glenshaw Glass Co., 348 U.S. 426; Park & Tilford Distillers Corp. v. United States, 107 F. Supp. 941, 123 Ct.Cl. 509. . . .

If the foregoing analysis is correct, the property reconveyed to the plaintiff was taxable income. I think it should be treated as such. The comparable recoveries, in the cases of bad debts and refunds of taxes, were so treated under the judge-made law which preceded the enactment of section 22(b)(12) and are so treated under that section. If Congress, in enacting section 22(b)(12) had chosen to provide in it for the meticulous recomputation which the court's opinion requires, that would have been a reason for the court's doing so in this analogous case not covered by the statute. Since Congress did not regard such a recomputation as necessary to do equity in the numerous cases covered by the statute, I think the plaintiff's unusual situation should not be accorded a treatment different from that accorded other taxpayers whose claims to equitable treatment are exactly equivalent to those of the plaintiff.

LARAMORE, JUDGE, joins in the foregoing dissenting opinion.

REVENUE RULING 59-141

Internal Revenue Service, 1959. 1959-1 Cumulative Bulletin 17.

The Internal Revenue Service will not follow the decision in the case of *William F. Perry et ux. v. United States,* 160 F.Supp. 270, as a precedent in the disposition of similar cases. In this case, the United States Court of Claims held that the return to the grantor of the corpus of a charitable trust constituted a nontaxable return of capital even though the grantor had realized full tax benefits from charitable deductions allowed for transfers to the trust in prior tax years. The court stated that the taxpayer should only add to the tax otherwise due in the year of repayment in amount of the taxes which had been saved as a result of the deductions previously taken.

This approach is contrary in principle to a long line of judicial authority holding that recovery of previously deducted items

constitutes taxable income in full in the year of recovery if the taxpayer had realized a full tax benefit from deductions taken in prior tax years. See *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, Ct.D. 1679, C.B. 1947–1, 109, and *Estate of William H. Block,* 39 B.T.A. 338. It is also contrary to the Internal Revenue Service's published position on the matter. See Revenue Ruling 54–566, C.B. 1954–2, 96. Accordingly, similar cases will be disposed of in conformity with established judicial doctrine and the prior published ruling, pending further judicial development of the issue.

Income of Decedents

In 1934, Congress amended the income tax law so as to provide that when a taxpayer died, his final return should include all items accrued at the date of his death, even though his returns had regularly been on the cash basis. The Supreme Court gave this provision a construction which seemed unwarrantedly broad, and held that all payments to become due with respect to services performed by the taxpayer before his death should be included in his final income tax return, even though such payments would not be regarded as having "accrued" in the usual sense of that term since the services had not been completed, and bills had not been rendered. *Helvering v. Estate of Enright,* 312 U.S. 636 (1941). This had the effect in many cases, particularly of lawyers and other professional men, of throwing several years' income into one taxable period, with consequent increase in the income taxable in the higher brackets.

To deal with this situation, Congress in 1942 enacted the provision now found in sec. 691 of the 1954 Code, and made corresponding amendments in the provisions now found in secs. 451(b) and 461(b).

Section 691 has the effect of taxing "income in respect of decedents" to the person who receives it, with a deduction allowed for the amount of any estate tax paid with respect to the item so received.[1]

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[1] For general discussion, see Kennedy, "Income Tax Problems of Decedents and Their Estates," 48 Northwestern U.L.Rev. 36 (1953); Drye, "The Taxation of a Decedent's Income," 8 Tax L.Rev. 201 (1953); Craven, "Taxation of Income of Decedents," 102 U. of Pa.L.Rev. 185 (1953). See also Scott, "A Critique of Section 126," 26 Taxes 127 (1948); Roehner, "Effect of Section 126 on Business Liquidation Agreements," 80 J. of Accountancy 364 (1945); Guterman, "Income of Decedents—New Problems in Income and Estate Taxes under Section 126," Proceedings of New York University Fourth Annual Institute of Law 24 (1946), also in 24 Taxes 633 (1946).

Cf. Dunkle, "Partnership Income: Allocation to Proper Accounting Period on Death of Partner," 5 Tax L.Rev. 568 (1950).

For a comprehensive consideration of this provision and the problems under it, see "Income in Respect of Decedents: The Scope of Section 126," 65 Harv.L.Rev. 1024 (1952). See also Windhorst, "Income in Respect of a Decedent," 37 Taxes 1082 (1959); Wright, "Taxation of 'Income in Respect of a Decedent,'" 31 Neb.L.Rev. 522 (1952); Hock, "Income and Property of Decedents and Their Estates," 34 Taxes 351 (1956).

Change of Accounting Method

May a taxpayer change from the cash to the accrual basis, or vice versa? See sec. 446(c) of the 1954 Code, and sec. 1.446-1(e) of the Income Tax Regulations; Knight, "Changes in Accounting Methods," 33 Taxes 351 (1960). On change from the accrual to the installment basis, see sec. 453(c) of the 1954 Code. Suppose a taxpayer changes from the accrual basis to the cash basis. Must he include as income amounts which he receives in the later year representing sales which were accrued in the earlier year? See *Mount Vernon Trust Co. v. Commissioner*, 75 F.2d 938 (C.C.A.2d, 1935), cert. den. 296 U.S. 587 (1935).

BROOKSHIRE v. COMMISSIONER

United States Court of Appeals, Fourth Circuit, 1960. 273 F.2d 638.

THOMSEN, DISTRICT JUDGE. Petitioners Stanford R. Brookshire and Voris G. Brookshire are partners trading as Engineering Sales Company. The other petitioners are their wives. In 1952 the partnership voluntarily, without seeking or obtaining permission from the Commissioner of Internal Revenue, changed its method of keeping its books of account and its method of reporting its income for federal income tax purposes from the cash receipts and disbursements method of accounting to the accrual method. The Tax Court sustained the action of the Commissioner requiring the partnership (1) to include in its 1952 income the monies collected in 1952 on accounts receivable existing as of 1 January 1952, representing sales made but not paid for in 1951, and (2) to reduce the cost of goods sold by that part of the inventory on hand 1 January 1952 which had been paid for and deducted from the partnership's income in prior years. The petition for review challenges those rulings. . . .

The partnership originally operated as a manufacturer's agent, selling on a commission basis, taking no title to the merchandise, and assuming no responsibility for the collection of accounts. The books were set up on a cash receipts and disbursement method of accounting. Monthly and annual profit and loss statements were prepared on that basis. The partnership income tax returns for all years before 1952 were prepared on the cash basis;

the figures used in computing income were taken solely from the cash receipts journal and the cash disbursements journal.

About 1940 the partnership began to make credit sales, and opened a cash receivable ledger for collection purposes. It also maintained a sales journal, in which invoices were listed by number and notations were made as to dates of payments. The entries in this journal were never totaled; they were used for cross-reference purposes only. For some years the inventory consisted solely of V-belts and material left over from such belts. About 1943 the partnership began to take a physical inventory at the end of each year and to prepare, for managerial information and occasionally for bank and credit reports, a balance sheet showing accounts receivable, accounts payable, and inventory. About 1945 the partnership began to make purchases for inventory, but before 1952 it maintained no accounts payable ledger. Neither the accounts receivable ledger, the sales journal nor the inventories were used in computing or reporting income.

The records and returns for 1948 and prior years were examined by an agent of the Internal Revenue Service sometime after 1948. Stanford Brookshire testified that this agent said it would be a good idea for the partnership to go on an accrual basis; the agent did not say that an accrual basis was required, and the returns were accepted on the cash basis. The method was not changed at that time, because the partners did not think it was necessary.[2] The Tax Court found that the cash receipts and disbursements method of accounting clearly reflected the income of the partnership for the years before 1952.

In 1952 a general ledger was set up. Accounts receivable, accounts payable and inventory existing as of 1 January 1952 were entered in this ledger with proper offsetting credits to the partners' capital accounts. The partnership did not request or receive permission from the Commissioner to change its method of accounting and reporting income,[3] but the partnership return for 1952 was prepared and submitted on an accrual basis. In that return the partnership did not include in income the amount of the accounts receivable existing as of 1 January 1952, or the collections thereon during that year; in computing the cost of goods sold, credit was taken for the full amount of inventory on hand 1 January 1952, including items which had been paid for and deducted prior to 1952.

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[2] The change was made as of 1 January 1952, when the amount of inventory on hand had greatly increased and it was advantageous to petitioners to make the change, provided they were not required to make the adjustments at issue in this case.

[3] As required by T.R. 111, Sec. 29.41–2 [now found in sec. 1.446(e)(2) of the Income Tax Regulations. Ed.]

The Commissioner accepted the 1952 return on the accrual basis, but increased the partnership's 1952 income (1) by the amount of the cash collected in 1952 on the accounts receivable representing 1951 sales and (2) by the net amount of the merchandise inventory which had been deducted from income both in 1951 and in 1952.[4] This determination was approved by the Tax Court.

Taxpayers' contention seems to be: that in the years before 1952 the partnership was engaged in the purchase and sale of merchandise to a substantial degree, sold on open account, and had substantial inventories of merchandise and accounts receivable; that under T.R. 111, sec. 29.41–2, the cash method of accounting did not correctly reflect the net income for those years; so, despite the fact that during all of those years it kept its books on the cash basis and deliberately filed its tax returns on the cash basis, its action in so doing was erroneous, and the Commissioner had no right, in the year of change, to increase the income by items which taxpayers contend were properly income of a prior year or years.

Section 41 of the 1939 Code provided that net income should be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer; but "if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income".

During all years before 1952, the books of the partnership were kept on a cash basis. Taxpayers prepared their income tax returns on that basis and they were accepted by the Commissioner, who did not and does not question the adequacy of that basis for the years prior to 1952. T.R. 111, sec. 29.41–2 states in part that

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4 In explanation of the adjustments made for 1952, the Commissioner stated: "* * * By reason of the change cash in the amount of $32,402.54 collected in 1952 from sales made in 1951 was not included in sales reported in the partnership returns for either year. In order to correctly reflect income it is determined that this amount must be added to taxable income for the year 1952 as a necessary adjustment incident to the partnership's change in its method of accounting. * * * By reason of the change, the merchandise inventory valued at $62,679.22 on January 1, 1952, was deducted from income in the partnership's returns for both of the years 1951 and 1952. In order to correctly reflect income it is determined that partnership is not entitled to the deduction in 1952 of the amount of the previously deducted inventory. As an offsetting adjustment to cost of goods sold it is determined, for the same reason, that the partnership is entitled to deduct the cost, $10,473.26, of merchandise purchased in 1951 but not paid for until 1952, and which was not deducted in its returns for either year. Accordingly, the cost of goods sold as reported in the 1952 return has been disallowed to the extent of the net amount of these adjustments, or $52,205.56."

In the alternative, the 90-day letters determined that the partnership income for the years 1950 and 1951 should be adjusted to the accrual basis, plus adjustments for the year 1950 for inventories and accrued accounts receivable (less accounts payable) representing income not previously taxed.

"in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method." However, as the Tax Court noted, some reasonable flexibility must be permitted in determining when the purchase and sale of merchandise becomes such an income producing factor as to require the use of inventories and a change to an accrual method, in order to reflect clearly the income of a taxpayer. In some instances either method may clearly reflect the income.

The Tax Court found that the cash method clearly reflected the income of the partnership for the years before 1952. That finding was supported by opinion evidence and by other facts in the record; we cannot say that it was wrong.

Petitioners are not in the position of taxpayers who reported their income *incorrectly* in the past. On the contrary, they are taxpayers who, having kept their books and reported their income *correctly* on the cash basis, *voluntarily* changed their accounting method. Consequently, T.R. 111, sec. 29.41–2 required that they obtain the Commissioner's consent to the change in method and provided that the Commissioner's consent might be conditioned upon adjustments designed to prevent items being "duplicated or entirely omitted as a result of the proposed change". Actually petitioners did not apply for or receive the Commissioner's consent, but their failure to do so did not increase their rights or lessen their obligations. The adjustments required by the Commissioner were designed to prevent items from being duplicated or entirely omitted as a result of the change, and were justified by the facts.

It would be idle to attempt to reconcile all of the cases, but the decisions relied on by petitioners are distinguishable on one or both of two grounds. Some, e. g. *Welp v. United States,* 8 Cir., 201 F.2d 128, are distinguishable because the changeover was not made *voluntarily* by the taxpayer, but was *required* by the Commissioner. This distinction was emphasized by H.Rep.No. 1337, 83d Cong. 2d Sess., 3 U.S.Code Cong. & Adm.News (1954), p. 4017, at page 4303, which proposed the changes made by the 1954 Code. See also *Clement A. Bauman,* 22 T.C. 7, at page 12.

Other decisions, e. g. *Commissioner of Internal Revenue v. Dwyer,* 2 Cir., 203 F.2d 522, are distinguishable because, in those cases, the taxpayer had *mistakenly* failed to report income (or had mistakenly taken a deduction) in a year prior to the taxable year, because the taxpayer had failed to employ or apply a correct method of accounting in such prior year. This distinction was noted in *Advance Truck Co. v. Commissioner,* 9 Cir., 262 F.2d 388, 391.

In *Advance Truck,* as in the instant case, the taxpayer had properly used the cash method of accounting prior to the taxable year, and accordingly had not reported certain items which were not reportable under that method. The court said: "The accounts receivable of $20,431.48 had, as stated in *Goodrich v. Commissioner,* supra [8 Cir., 243 F.2d 686, 691], 'an income status created for them on a cash-realization basis,' under the cash receipts and disbursements method which the petitioner had employed as to them. We are unable to agree with the petitioner that such status was changed simply because the petitioner changed its method of keeping its books of account to the accrual method for the year 1950." 262 F.2d at page 391. In the instant case the Commissioner properly determined that the accounts receivable on the books 1 January 1952 should be considered income as and when they were collected.

The adjustments required by the Commissioner were made to prevent duplications or omissions resulting from the voluntary changeover. They were not made to correct errors of past years. The Tax Court did not err in approving the determination of the Commissioner.

Affirmed.

Note

For 1954, and later years, the question is now governed by sec. 481 of the 1954 Code, a new provision in the new Code, which provides complicated adjustments in a case of change of accounting method, and allows the tax to be computed by spreading the increase over a period of three years.

Regulations have been issued under this section as secs. 1.481–1.481–6(d) of the Income Tax Regulations.

See Dakin, "The Change From Cash to Accrual Accounting for Federal Income Tax Purposes—Pyramided Income, Double Deductions and Double Talk," 51 Northwestern U.L.Rev. 515 (1956), also in 35 Taxes 782 (1957). See also Richardson, "Accounting Methods and Changes Therein," 35 Taxes 924 (1957; "Problems Arising from Changes in Tax-Accounting Methods," 73 Harv.L.Rev. 1564 (1960).

COMMISSIONER v. AMERICAN LIGHT & TRACTION CO.

United States Circuit Court of Appeals, Seventh Circuit, 1946. 156 F.2d 398.

SPARKS, CIRCUIT JUDGE. This is a petition to review a decision of the Tax Court that dividends declared in December, 1936, to stockholders of record as of dates during that month, but payable in 1937, are income to the taxpayer in the latter year even though it is on an accrual basis.

In rendering its decision, the Tax Court stated that in the case of *Falmouth Co. v. Com'r (Tar Products Corporation v. Com'r),*

reported in 45 B.T.A. 1033, the court had before it a similar state of facts, and that it there held that the date of *declaration* and not the date fixed for *payment* controlled the taxability of corporate dividends received by a taxpayer using the accrual method of accounting. On appeal, the Court of Appeals for the Third Circuit reversed, holding that the date of *receipt,* and not the declaration date controlled. 130 F.2d 866. It will be noted that neither Board nor court appears to have considered the possible applicability of a fourth date to the issues there involved, namely, the *record* date, the date which fixes the identity of the shareholders to receive the dividend theretofore declared. Similarly, in the case at bar, the Tax Court does not appear to have considered the possible applicability of the record date, stating that the facts of the two cases were indistinguishable, and that it yielded to the opinion of the Third Circuit court without discussing the relative merits of the two opinions, being convinced that the importance of the question lay in the promptness and certainty of the answer.

Before this court, the Commissioner contends that the Tax Court was in error for the reason that the controlling date for taxpayers on the accrual basis should be the record date. This particular question, of the applicability of the record date for determining the inclusion of dividends in gross income of a taxpayer on the accrual basis, does not appear to have been squarely presented to the courts until the case at bar.[1] In fact, there is nothing in the record or in the opinion of the Tax Court to indicate that the Commissioner urged this contention before it. The problem is suggested by the Court in *Estate of Putnam v. Com'r,* 324 U.S. 393, decided after the Tax Court's decision in the case at bar. The *Putnam* case involved the construction of § 42 of the Revenue Act of 1938, with reference to the taxability of dividends declared before the death of a taxpayer, payable to shareholders of record at varying dates after his death. Inasmuch as the three dates, of record, payment, and receipt, occurred after the death of the taxpayer, it was unnecessary for the Court to determine which of those three controlled in the case of a taxpayer on the accrual basis, and it decided only that the date of declaration did not control, and reversed the Court of Appeals for the Second Circuit, 144 F.2d 756, accordingly.

So the particular question has remained open, although it has been narrowed down to this point by the cases. It has been fully settled that, as to a taxpayer on a cash-disbursements basis, the date of receipt of income controls, and not the date of payment. *Avery v. Com'r,* 292 U.S. 210. It has been equally well

[1] See Journal of Accountancy, November, 1945, p. 353, When Does A Dividend Become Income, by George G. Tyler.

settled that the *right* to receive, and not the actual receipt, determines the inclusion of amounts in gross income in the case of a taxpayer on the accrual basis. *Spring City Foundry Co. v. Com'r,* 292 U.S. 182.

Respondent contends, and the appellate court held in the *Tar Products* case, *supra,* that this latter principle does not apply in the case of dividends because of a special statutory definition and applicable departmental regulation, "The term 'dividend' * * * means any distribution made by a corporation to its shareholders * * *" § 115 of the Revenue Act of 1936. Article 115–1 of Treasury Regulations 94, promulgated under this Act, provides: "A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands."

Petitioner contends, and the Board of Tax Appeals held in the *Tar Products* case, that the language of the regulation has reference only to the doctrine of constructive receipt, hence is limited in its applicability to taxpayers on the cash-disbursements basis. This contention was carefully considered by the Appellate Court in the *Tar Products* case, and it concluded that the language of the Act and regulation, identical from 1921 on down, never had made any distinctions as to the time when the dividend became income according to the method of bookkeeping used by the taxpayer, and that no reason appeared why it should be restricted as contended by the Commissioner.

The court further went on to point out reasons why the treatment of dividends should be subject to a single rule regardless of the bookkeeping methods of the taxpayer. "It makes possible the checking of taxpayer's returns against the corporation record of disbursements. It will prevent variations in the tax to be paid in those cases where dividends are paid in kind rather than in money and the value of the property fluctuates." A further reason for the single rule is suggested by Tyler in the article referred to above (note 1). Under § 115(a) of the Act, a distribution, in order to be a taxable dividend rather than a return of capital, must be paid out of earnings and profits of the corporation. But the amount of earnings and profits available to pay a dividend has been determined as of the time of payment rather than the date of declaration. *Mason v. Routzahn,* 275 U.S. 175. Thus it might occur that a dividend declared December 15, 1944, payable January 31, 1945, to stockholders of record December 31, 1944, might be nontaxable to the accrual basis stockholder because a return of capital, if there were no earnings in 1944 with which to pay the dividend, although it would be taxable to cash basis shareholders if there were 1945 earnings sufficient to pay it. It might also be subject to double taxation if a transfer from

an accrual basis stockholder to a cash basis one occurred between the record date and the date of payment.

All of these reasons appear to us to be quite persuasive for the adoption of the single rule for the treatment of taxability of corporate dividends, although, as pointed out by the Third Circuit, none would be conclusive if Congress actually enacted a contrary rule. In the absence of such Congressional enactment, we agree with the reasoning of that court, and with the action of the Tax Court in the case at bar in yielding to its decision. . . .

Decision affirmed.

COMMISSIONER v. PHILADELPHIA TRANSPORTATION CO.

United States Court of Appeals, Third Circuit, 1949. 174 F.2d 255.

GOODRICH, CIRCUIT JUDGE. The Philadelphia Transportation Co., the taxpayer here, was formed on January 1, 1940 as the culmination of reorganization proceedings involving 65 corporations concerned in Philadelphia's public transportation system. In accordance with the reorganization plan, the taxpayer issued, in January, 1940, mortgage bonds dated January 1, 1939 and bearing interest from that date. The interest coupons for 1939 and 1940 were redeemed by the taxpayer in 1940, as required by the reorganization plan.

The taxpayer computes its tax liability on an accrual basis. In its income tax return for 1940, it claimed a deduction for the 1939 and 1940 coupons as "interest accrued" in 1940.[1]

These basic facts raise the crucial question, the answer to which will dispose of the case. Was the interest allocated as 1939 interest properly deducted from the taxpayer's 1940 income as interest accrued in 1940? The Tax Court held that it was. In this appeal, the Commissioner seeks reversal on three principal grounds. He argues, first, that the amount deducted was not interest. It was not interest, he says, because interest is compensation for the use of money, and the taxpayer held no money, borrowed or otherwise, in 1939. The Commissioner looks for support on this point to the statutory language which refers to "interest accrued on indebtedness." He concludes that without indebtedness in 1939, there could have been no interest. And there was no indebtedness in 1939, he says, because the taxpayer had no corporate existence then.

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[1] The applicable section of the Internal Revenue Code, § 23(b), provides: "§ 23. Deductions from gross income. In computing net income there shall be allowed as deductions: * * *

(b) Interest. All interest paid or accrued within the taxable year on indebtedness * * *."

The Commissioner's second point is that the taxpayer really took over the obligation to pay 1939 interest as a part of the cost of the assets acquired in the reorganization. We discuss this point below. And finally the Commissioner argues that even if the amount in question be treated as interest, a deduction of interest for more than the current year may not be made from that year's income.

The point last stated is easily answered. No provision of the Internal Revenue Code prohibits such a deduction. Section 43 of the Code provides that the liabilities of one year cannot be used to reduce the income of a subsequent year. It is upon the provision that the Commissioner relies. But the issue is whether the item in question here is a liability of the year 1940. If it accrued in 1940, it is deductible in 1940 and in no other year, whether or not it is based on transactions allocated for other purposes to other periods. One decision specifically supports the deduction of 2 years' interest in one year in a proper case,[2] and three other decisions, including one from this Court, support the proposition in principle.[3]

We turn, then, to the Commissioner's first two arguments. We think that the fog surrounding the no debt-no interest contention is best cleared by a simple hypothetical illustration. A corporation is formed in 1940. It is brand new and without corporate forebears. It issues in 1940 a series of 20-year coupon bonds. For reasons best known to the management, it is decided to date the bonds as of January 1, 1939 to mature January 1, 1959, and to redeem the first two interest coupons in 1940. The corporation pays its taxes on an accrual basis. Can there be any doubt that the interest accrued on the two coupons in 1940 and was properly deductible in that year? We think that in the hypothetical case the situation is the same as if the 1940 interest coupons were just double the later ones in amount. There was indebtedness in 1940, interest accrued on that indebtedness in 1940, and we think it is chargeable for tax purposes, as well as bookkeeping purposes, for that year.

We think the present case is similar to the hypothetical one in all respects except that the taxpayer was the product of a reorganization and came into existence with the obligation to pay fixed and variable interest on the bonds it was to issue to the shareholders of its corporate predecessors. These added factors

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2 Oregon Pulp & Paper Co. v. Commissioner, 1942, 47 B.T.A. 722, petition for review dismissed, C.C.A. 9, November 2, 1943.

3 Commissioner v. Pressed Steel Car Co., Inc., 3 Cir., 1945, 152 F.2d 280; Ernst Kern Co. v. Commissioner, 1942, 1 T.C. 249; Columbia River Paper Mills v. Commissioner, 1940, 43 B.T.A. 104, affirmed 9 Cir., 1942, 126 F.2d 1009. It is true that our decision was made at a time when the Dobson case blinders prevented the judicial eye from roving over the record. We think the result was right though perforce compelled.

do not, in our judgment, alter the result. The taxpayer, as a new corporation, created its own new indebtedness. It did not assume existing liabilities on which interest had already accrued against predecessor companies. If it had, there would be merit in the Commissioner's point that the obligation was part of the cost of the assets acquired by the taxpayer.[4]

But that is not the fact. No obligation was owed by the predecessor companies to their shareholders except insofar as assets might have remained for distribution to them when corporate affairs were wound up. Moreover, neither the present taxpayer nor any of its predecessors was in a position to take advantage of a 1939 deduction for the interest payments in question. As our brethren in the Ninth Circuit said in *Commissioner v. Columbia River Paper Mills,* 1942, 126 F.2d 1009, 1010: "The arrangement was a logical one under the circumstances, * * *. It is not suggested that there was any purpose of tax avoidance * * *." We conclude, therefore, as we did in *Pressed Steel Car Co. v. Commissioner,* 3 Cir., 1946, 152 F.2d 280, that the Tax Court correctly decided that the amount in dispute represented accrued interest within the meaning of Section 23(b) of the Internal Revenue Code.[5]

The decision of the Tax Court will be affirmed.

WALLER, CIRCUIT JUDGE (dissenting). It is with regret that I cannot bring myself in line with the excellent opinion of the majority in this case. I cannot escape the force of innumerable opinions of courts throughout the country holding that interest is the premium paid for the use of money, or—as held by the Supreme Court in *Deputy, Administratrix v. DuPont,* 308 U.S. 488, text 497—that interest "is the amount which one has contracted to pay for the use of borrowed money."

In 1939 the taxpayer here borrowed no money, acquired no property, used no money or property of others, and owed no

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[4] Cases in which the indebtedness was that of the taxpayer's vendor or predecessor, and was taken over by the taxpayer with the obligation to pay interest already accrued, have been properly treated as capital transactions. Commissioner v. Breyer, 3 Cir., 1945, 151 F.2d 267, 272; Rodney Inc. v. Commissioner, 2 Cir., 1944, 145 F.2d 692; Pratt-Mallory Co. v. United States, 1936, 12 F.Supp. 1020, 1023, 82 Ct.Cl. 292. Cases like Lloyd v. Commissioner, 3 Cir, 1946, 154 F.2d 643, in which the proceeds of the sale of unmatured interest coupons by a banking syndicate which was not the obligor were held improperly declared as a deduction for payment of "interest," are clearly without application to the present case.

[5] All the authorities on this point have reached the same result, with one exception. Commissioner v. Pressed Steel Car Co., Inc., 3 Cir., 1945, 152 F.2d 280; Ernst Kern Co. v. Commissioner, 1942, 1 T.C. 249; Columbia River Paper Mills v. Commissioner, 1940, 43 B.T.A. 104, affirmed 9 Cir., 1942, 126 F.2d 1009; Oregon Pulp & Paper Co. v. Commissioner, 1942, 47 B.T.A. 722, petition for review dismissed, C.C.A. 9, November 2, 1943. Contra: Commissioner v. Drovers Journal Publishing Co., 7 Cir., 1943, 135 F.2d 276.

debts to which interest could have been an incident. On the contrary it was not in existence until January 1, 1940, and neither made, nor could have made, any contract prior to its coming into being. It, doubtless, could have ratified, upon its organization, lawful contracts theretofore made by its promoters, but the procedure adopted was not that of ratifying a prior contract made by its promoters but of making its own contract whereby it sought to engage in the Canutian pastime of turning back the tide for one year and thus to pay interest on money which it never used nor borrowed in 1939, but with which it purchased property in 1940.

The bonds were issued for the acquisition of the assets of the sixty-five affiliated companies. The consideration for the purchase of such assets was the execution and delivery of bonds and interest coupons thus ante-dated. Before its organization no assets were delivered to it, no money advanced, no forbearance extended. In short, bonds with one year's unearned and unaccrued interest coupons were delivered in consideration for the sale of such assets.

It seems clear that the payment represented by the 1939 coupons was not a payment of "interest" but was merely a part of the consideration for the acquisition of the assets acquired in part therewith, and as such was a capital investment rather than rent for the use of money or its equivalent.

COMMISSIONER v. PHILADELPHIA TRANSPORTATION CO.

Supreme Court of the United States, 1949. 338 U.S. 883.

On writ of certiorari to the United States Court of Appeals for the Third Circuit.

PER CURIAM:

The judgment is affirmed. MR. JUSTICE BURTON dissents.

ZIMMERMAN STEEL CO. v. COMMISSIONER

United States Circuit Court of Appeals, Eighth Circuit, 1942, 130 F.2d 1011.

WOODROUGH, CIRCUIT JUDGE. The petitioning taxpayer (which is now in bankruptcy) seeks review of a decision of the Board of Tax Appeals sustaining the Commissioner's deficiency assessments for the tax years 1936 and 1937, based upon the refusal of the Commissioner to allow the taxpayer deductions which it claimed on account of interest accrued upon its debt for those years as shown on its books kept on the accrual basis. The findings of fact made by the Board appear with the Board's opinion, reported 45 B.T.A. 1041.

The Board based its decision that the interest upon the taxpayer's debt accruing during the tax years in question was not deductible under Revenue Act of 1936, c. 690, 49 Stat. 1648, § 23(b), upon the finding, which it deduced from the circumstances, that "There was no reasonable probability that such interest [shown as accrued items on the taxpayer's books] would ever be paid." It observed that "the rule is that a taxpayer on an accrual basis is not required to report as income in his return an amount which he may never receive", and stating that "principles pertaining to the accrual of income should also be applied to deductions", it reached the conclusion that the obligations of the taxpayer to pay interest on its debt could not be deducted as "interest * * * accrued within the taxable year on indebtedness" within the intendment of the statute, supra. The taxpayer asserts that the conclusion was erroneous and so presents the question which is for our determination.

Though it is earnestly insisted for the government that the conclusion of the Board was without error, it is admitted in the brief that "there are no court decisions directly holding that an accrued item of expense may not be deducted when there is no reasonable expectancy that it will be paid." Our own search has confirmed the admission. The law is that if a method of bookkeeping employed by a taxpayer "does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income" (Section 41), and the real facts, not forms of entry, must measure the tax. But where interest actually accrues on a debt of a taxpayer in a tax year the statute plainly says he may deduct it. That he has no intention or expectation of paying it. but must go into bankruptcy as this taxpayer was obliged to do, can not of itself justify denial of deduction in computing the taxpayer's net income. It is true that if a man's gains at the end of the year consist of bad debts he can have no net income to tax. But neither does he have such net income if the interest on what he owes amounts to more than his gains.

In *Helvering v. Jane Holding Company,* 8 Cir., 109 F.2d 933, 942, we dealt with a situation where an accrued item of interest was shown on a taxpayer's books as owing to a creditor, but the debt was forgiven by the creditor and therefore was not really a debt of the taxpayer. Under such circumstances there would be no "items of interest accrued" and no allowable deduction on account of one. But in this case the Board did not find that the interest debt shown on the taxpayer's books had been forgiven by the creditor. Its statement in the opinion is that the facts which are recited "strongly indicate a forgiveness of the interest" but this expression falls short of a finding that there was such forgiveness.

It is argued for the taxpayer that the question whether its obligation in respect to the interest owing by it had been forgiven was not open on the hearing before the Board and that the parties had "stipulated the amount of the indebtedness and the interest". We do not find such a stipulation in the record and as the burden was upon the taxpayer to establish its right to the deduction claimed by it, we can discern no reason to declare that the Board may not inquire into the matter.

We conclude that the decision of the Board on the facts which were found by it was erroneous. It is therefore reversed and the cause is remanded for further proceedings.

Reversed and remanded.

Notes

(A) In *Brainard v. Commissioner,* 7 T.C. 1180 (1946), the Tax Court refused to follow the *Zimmerman Steel* case. But this was vacated on stipulation by the Circuit Court of Appeals for the Seventh Circuit. It thus appears that the Department of Justice is not willing to contend contrary to the *Zimmerman* case. See also I.T. 3635, 1944 Cum.Bull. 101, where the Bureau seems to follow the *Zimmerman* case.[1]

(B) But *cf. Prudence Securities Corp. v. Commissioner,* 135 F.2d 340 (C.C.A.2d, 1943), where all of the bonds and all of the stock of the taxpayer corporation were owned by its parent. No interest had ever been paid on the bonds. The court held that no deduction could be taken for accrued interest.

(C) In *Barker v. Magruder,* 95 F.2d 122 (App.D.C., 1938), noted in 51 Harv.L.Rev. 1295 (1938), it appeared that two corporations were owned by the same interests, and that one of them had made loans to the other at a usurious rate of interest. Under the local law, the lender in such a transaction may recover only the principal. The lender was on the accrual basis and set up the accrued interest as income on its books. A receiver was appointed for the lender, and the collector filed a claim for taxes which included the accrued interest as income. The Court held that the interest had accrued and was taxable, despite the fact that there was no legally enforceable obligation.

(D) In *Franklin County Distilling Co. v. Commissioner,* 125 F.2d 800 (C.C.A.6th, 1942), a producer of whiskey issued warehouse receipts. It was held that storage charges provided for in the receipts were accrued income, although the holders of the warehouse receipts were unknown to the producer.

(E) A railroad company, on the accrual basis, owned certain bonds in another railroad. In 1938, the obligor notified all bondholders that it did not have the cash to meet all of its obligations due during that year, and proposed a Plan and Agreement under Chapter XV of the Bankruptcy Act. Under this Plan and Agreement, the obligor was to pay 25% of the interest due in 1938, 1939 and 1940, and the remaining 75% was to be paid without

[1] See Starr, "Deductibility of Accrued Interest When Payment is Uncertain," 27 Taxes 195 (1949).

interest within five years of the respective due dates. This was accepted by the bondholder, and approved by the District Court. The deferred interest was eventually paid in installments during the years 1942 to 1945.

It was held that all of the interest accrued during 1938, 1939, and 1940, and was to be included in gross income for those years. *Union Pacific Railroad Co.*, 14 T.C. 401 (1950).

(F) *Foreign exchange.* Cases involving foreign currencies present difficult questions of determining the existence and the amount of income, gain or loss. See *Frederick Vietor & Achelis v. Salt's Textile Mfg. Co.*, 26 F.2d 249 (D.Conn.1928); Bailey, "Creditors' Losses on Foreign Currency Loans," 31 Taxes 476 (1953); "Taxation of Foreign Currency Transactions," 61 Yale L.J. 1181 (1952); Shepard, "Foreign Exchange—Tax Consequences," 1 Tax L.Rev. 232 (1946); Roberts, "Borrowings in Foreign Currencies," 26 Taxes 1033 (1948). See also *Willard Helburn, Inc. v. Commissioner*, 214 F.2d 815 (C.A.1st, 1954), set out at p. 219, above.

TAFT v. HELVERING

Supreme Court of the United States, 1940. 311 U.S. 195.

Mr. Chief Justice Hughes delivered the opinion of the Court.

Petitioners, husband and wife, filed joint income-tax returns for the years 1934 and 1935. In computing their aggregate net income under Section 51(b) of the Revenue Act of 1934,[1] they made deductions of their combined charitable contributions.[2] The Commissioner ruled that the deductions on account of the wife's charitable contributions should be reduced to 15 per cent of her separate net income and deficiencies were determined accordingly. The Board of Tax Appeals sustained the Commissioner (40 B.T.A. 229) and the Circuit Court of Appeals affirmed. 111 F.2d 145. . . .

The provision for joint returns in Section 51(b) of the Revenue Act of 1934 was in substantially the same form as the corresponding provision in the prior revenue acts from 1921. The import of that provision is that in making a joint return the husband and wife should report their aggregate gross income and could combine their deductions in reporting their aggregate net income upon which the tax was to be computed. That was the construction placed upon the original provision for joint returns, in the Revenue Act of 1918, by the Solicitor of Internal Revenue. He said in his ruling: "If a single joint return is filed it is treated as the return of a taxable unit and the net income disclosed by the return is subject to both normal and surtax as though the return were that of a single individual. In cases, therefore, in

1 48 Stat. 697.

2 Section 23(o), 48 Stat. 690.

which the husband or wife has allowable deductions in excess of his or her gross income, such excess may, if joint return is filed, be deducted from the net income of the other for the purpose of computing both the normal and surtax".[3] We think that this was the intention of Congress in enacting the Act of 1921 [4] and the later acts containing the same provision for joint returns. We think that it was also the fair import of the Treasury Regulations under the Act of 1921 and of subsequent regulations prior to 1934.[5]

Respondent places emphasis on the phrasing of Article 401 of Regulations 62 under the Act of 1921, that "in a single joint return, the tax is computed on the aggregate income and all deductions and credits to which either is entitled shall be taken from such aggregate income". The argument stresses the words "to which either is entitled" and it is urged that each spouse is entitled only to deduct 15 per cent of his or her separate net income. But we think that this is an inadmissible construction of the statute and is not a necessary construction of the regulation. Such a construction is inconsistent with the premise of the Solicitor's opinion, above mentioned, that a joint return "is treated as the return of a taxable unit" and the tax is to be laid as though the return were that "of a single individual". The more specific language of the provision in the Act of 1921, which for the present purpose is the same as that in the Act of 1934, affords a stronger basis for this conclusion. It provides specifically for the inclusion of the income of each spouse "in a single joint return" and in that case that "the tax shall be computed on the aggregate income". The principle that the joint return is to be treated as the return of a "taxable unit" and as though it were made by a "single individual" would be violated if in making a joint return each spouse were compelled to calculate his or her charitable contributions as if he or she were making a separate return. The principle of a joint return permitted aggregation of income and deductions and thus overrode the limitations incident to separate returns. We find no indication in Article 401 of Regulation 62 under the Act of 1921 of any intention to depart from the Solicitor's view as to the purport of the statute.

In 1935, by Article 23(o)-1 of Treasury Regulations 86, the Department sought to require a husband and wife, whether they make "a joint return or separate returns", to base their deduction for charitable contributions on the separate net income of the spouse making them. We are of the opinion that under the Reve-

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3 Sol.Op. 90, Cum.Bull. No. 4, p. 236 (1921). See Helvering v. Janney, No. 36, decided this date.

4 House Rep. No. 350, 67th Cong., 1st Sess.; Sen. Rep. No. 275, 67th Cong., 1st Sess.

5 Treasury Regulations Nos. 65 and 69, Art. 401; Regulations Nos. 74 and 77, Art. 381.

nue Act of 1934, taken with the meaning we think it had when enacted, petitioners were entitled to the combined deductions they claimed, and that the departmental regulation to the contrary was ineffective to deprive them of that right.

The judgment of the Circuit Court of Appeals is reversed.

Notes

(A) At the same time, the Court decided *Helvering v. Janney,* 311 U.S. 189 (1940), in which it rejected the Treasury's effort to rule that capital losses of one spouse could not be deducted on a joint return from the capital gain of the other.[1]

(B) Under the provision now found in sec. 6013(b) of the 1954 Code, which was first added in 1951, married taxpayers may file a joint return even though they have previously filed separate returns for the taxable year.

(C) *Consolidated Returns.* Until 1934, corporations were allowed, if they chose, to file their returns on a consolidated basis if they met the statutory tests of affiliation. In 1934, consolidated returns were eliminated except for railroads. With the adoption of the excess profits tax in 1940, these provisions with respect to consolidated returns were restored. They are now found in secs. 1501–1505 of the 1954 Code. What is the purpose underlying consolidated returns? Do they result in an increase or decrease of revenue? It should be noted that corporations which elect to file consolidated returns are taxed at a rate two per cent higher than where separate returns are filed. See sec. 1503(a). Should this differential be retained? (It was eliminated as far as public utility holding companies and Western Hemisphere Trade Corporations are concerned, by the 1954 Code.)

When a group of corporations files a consolidated return, they elect to be bound by the consolidated return regulations issued by the Commissioner. See Section 1501. These regulations are very complicated, but they have gone far to eliminate controversy over the questions arising on consolidated returns.[2]

Note carefully the provision of sec. 482 of the 1954 Code (formerly sec. 45), under which the Commissioner is authorized to allocate items of income or deductions where two or more organizations are controlled by the same interests. See *G. U. R. Co. v. Commissioner,* 117 F.2d 187 (C.C.A.7th, 1941); "Income Tax Consequences of Sales of Assets between Related Corporations," 60 Col.L.Rev. 179 (1960); Sherman, "A Case History of Section 45," 29 Taxes 13 (1951); Cooper, "Section 45," 4 Tax L.Rev. 131 (1948); Swartz, "Transactions between Related Corporations," 26 Taxes 941 (1948); Holzman, "Arm's Length Transactions and

1 See "Income Taxation of Husband and Wife," 49 Yale L.J. 1279 (1940); "Status of Taxpayers on a Joint Return," 35 Ill.L.Rev. 321 (1940); Ratchford, "Joint Family Returns in the Federal Income Tax," 27 Bull.Nat.Tax Ass'n 133 (1942); Ritz, "The Married Woman and The Federal Income Tax," 14 Tax.L.Rev. 437 (1959).

2 See Dale, "Recent Consolidated Returns Cases—Can the Regulations Be Ignored," 11 Tax Exec. 158 (1959); Blitman, "Consolidated Returns in the Federal Tax System," 8 Nat.Tax J. 260 (1955); Hellerstein, "Losses Availed of in Consolidated Returns," 2 Tax L.Rev. 391 (1947).

Section 45," 25 Taxes 389 (1947). Earlier references include Magill, "Allocation of Income by Corporate Contract," 44 Harv. L.Rev. 935 (1931); Huston, "Allocation of Corporate Net Income," 26 Ill.L.Rev. 725 (1932).

GREAT WESTERN POWER CO. v. COMMISSIONER

Supreme Court of the United States, 1936. 297 U.S. 543.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The parties disagree as to petitioner's right to deduct from gross income for 1924 unamortized discount, premiums, and expenses paid and incurred in that year in connection with the retirement of certain bonds. The petitioner took the deduction in its income tax return. The respondent disallowed it and determined a deficiency. The petitioner appealed to the Board of Tax Appeals which held the deduction proper. The Circuit Court of Appeals reversed the Board's decision in part. We granted the writ to resolve a conflict.

March 1, 1919, the company executed a mortgage securing four series of bonds, one of which was designated "Series B 7%." February 1, 1921, the company executed another mortgage, securing bonds known as "General Lien Convertible 8% Gold Bonds," and thereby covenanted to deposit and pledge with the trustee Series B 7's equal in par value to the General Lien 8's at any time outstanding. The indenture provided that when this should be accomplished the debtor should have the right to redeem the General 8's at 105 and accrued interest, the holders to have the option to receive cash or Series B bonds, of equal face value, plus five per cent in cash. The General Lien 8's were issued at a discount of $150,000 and an expense of $22,283.54. Prior to December 31, 1923, certain General Lien 8's had been redeemed for cash and the then unamortized discount and expense allocable to the bonds retired had been charged off in the year of retirement. May 8, 1924, the company called the remaining outstanding General Lien 8's for redemption August 1, 1924. The holders of $2,354,000 face value exercised the option to exchange for Series B 7's at par and a cash premium of five per cent. The total premium paid to them was $117,725 and the expense of the conversion was $1,461.05. The unamortized discount and expense of issuance in respect of the General Lien 8's thus exchanged, at the date of exchange, was $126,176.97. For the remaining General Lien 8's, which were not exchanged for Series B 7's, cash was paid at the rate of 105 per cent of par and the company incurred certain expenses in the transaction. The total of the premium, the expense, and the unamortized discount applicable to all of the bonds redeemed for cash or in exchange for Series B bonds was charged off in 1924 and taken as a deduction from income for that year. The company keeps its accounts on

the accrual basis. The Commissioner disallowed the entire deduction, but before the Board he admitted the propriety of so much of it as applied to bonds redeemed for cash. He insisted, however, that as to those retired by exchange of the Series B 7's the discount, premium, and expense should be amortized over the life of the latter. The Board overruled his contention, but the Circuit Court of Appeals sustained it, holding that the items would not be deductible as realized losses until payment or redemption of the Series B bonds, and should be amortized in annual installments during their term.

Section 234(a) of the Revenue Act of 1924 directs that in computing the net income of a corporation subject to the tax there shall be allowed as deductions ordinary and necessary expenses paid or incurred during the taxable year in carrying on the business, interest paid or accrued within the year on indebtedness, and losses sustained during the year not compensated by insurance or otherwise. The Treasury promulgated a regulation under the Revenue Act of 1918 covering treatment of discounts and premiums, which, with immaterial changes, has remained in force under all the revenue acts and appears as Art. 545 of Regulations 65 applicable to the Revenue Act of 1924.[1]

Although the article does not expressly cover the items in question other than discount and premiums paid at redemption, expense in connection with the issuance of the securities is deductible on the same theory as unamortized discount.[2] It has accordingly been held that where an issue of bonds is retired for cash, whether the cash be obtained by the sale of a new issue or not the items in question are deductible in the year of retirement.[3]

The question then is whether, upon an exchange of one obligation for another which is to be retired, the transaction is to be

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1 "ART. 545. Sale and retirement of corporate bonds.— . . .

"(3)(a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year."

2 Helvering v. Union Pac. R. R. Co., 293 U.S. 282; Helvering v. Cal. Oregon Pr. Co., 75 F.2d 644.

3 Helvering v. Cal. Oregon Pr. Co., supra; Helvering v. Central States Elec. Corp., 76 F.2d 1011; Helvering v. Union Pub. Serv. Co., 75 F.2d 723; T.D. 4603, XIV C.B. 46, p. 3.

viewed as if the retirement were accomplished by the payment of cash. If the retired bonds had not been called, the expense items incurred in connection with their issuance would properly be amortized over the remainder of their life. Here the petitioner substituted a new obligation for the old. The remaining unamortized expenses of issue of the original bonds and the expense of the exchange are both expenses attributable to the issuance of the new bonds and should be treated as a part of the cost of obtaining the loan. They should, accordingly, be amortized annually throughout the term of the bonds delivered in exchange for those retired.

The judgment of the Circuit Court of Appeals is affirmed.

Affirmed.

Notes

(A) *Cf. Helvering v. Metropolitan Edison Co.,* 306 U.S. 522 (1939), involving the deduction of discount on bonds by a successor corporation into which the issuing corporation was merged.[4]

(B) The material in the Regulations with respect to "Sale and purchase by corporation of its bonds" is now found in sec. 1.61–12(c) of the Income Tax Regulations.

(C) In *Bridgeport Hydraulic Co.,* 22 T.C. 215 (1954), the taxpayer had bonds outstanding on which there was unamortized discount. These bonds were all held by three insurance companies. In 1945 these bonds were called, and were paid in cash. At about the same time the taxpayer sold a new issue of bonds to the same insurance companies. It was held that the unamortized discount on the old bonds, and the cost of retiring them, were deductible in full in 1945. However, in the same case, where some other bonds were retired by exchanging them for new bonds, it was held that the unamortized discount and expense on the old bonds was a part of the cost of the new bonds and should be spread over the life of the new bonds. On this latter point, the Tax Court followed its prior decision in *South Carolina Continental Telephone Co.,* 10 T.C. 164 (1948).

(D) The Old Colony Railroad issued some bonds at a premium before 1913. In *Commissioner v. Old Colony R. R.,* 26 F.2d 408

[4] See Lemke, "The Treatment of Unamortized Discount and Expense Applicable to Bonds Refunded before Maturity," 22 Accounting Rev. 379 (1947); Healy, "Treatment of Debt Discount and Premiums Upon Refunding," 73 J. of Accountancy 199 (1942); "Unamortized Bond Discount, Unamortized Issuance Expense, and Redemption Premium; Accounting Treatment and the Federal Income Tax," 56 Harv.L.Rev. 990 (1943); "Successor Corporation's Right to Deduction for Unamortized Discount on Assumed Bonds," 56 Harv. L.Rev. 1308 (1943); Gushee, "Bond Discount or Premium at Refunding," 21 Accounting Rev. 61 (1946). See also American Smelting and Refining Co. v. United States, 130 F.2d 883 (C.C.A.3d, 1943), noted in 56 Harv.L.Rev. 311 (1942).

(C.C.A.1st 1928), it was held that the premium was income before 1913, and that no part of it could be taxed by amortization in 1920. The Commissioner then changed his attack. The coupons on the bonds called for interest at five per cent. For the year 1921, the Commissioner contended that the company could not deduct the full five per cent as "interest paid," but that a portion of the coupon payment (corresponding to the amortized portion of the premium) was in fact return of capital, necessary to make the bondholder whole. The Commissioner argued that only the remaining portion of the coupon payment, or the "effective rate" of interest, was deductible. In *Old Colony R. R. v. Commissioner*, 284 U.S. 552, 561 (1932), the Supreme Court rejected this position, saying that "we think that in the common understanding 'interest' means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon, and that the words of the statute permit the deduction of that sum, and do not refer to some esoteric concept derived from subtle and theoretic analysis."

In *Helvering v. Union Pacific R. R.*, 293 U.S. 282 (1934), the question arose with respect to bonds issued at a *discount* before 1913. The Court held that an amortized portion of this discount might be deducted in the company's return for 1923. Is there any way to reconcile this decision with the *Old Colony R. R.* case?

For general discussion, see Molloy, "Federal Income Tax Aspects of New Trends in Railroad Corporate Finance," 12 Tax L. Rev. 113 (1957).

Problem

On October 1, 1956, X Corporation issued bonds in the face amount of $2,000,000 at a price of 92½. The expenses of the sale were $22,000. The bonds matured in 20 years but were callable at 105 at any time on 6 months' notice. Such notice was given early in 1959, payment to be made on October 1, 1959. At that time the holders were given the option of receiving (1) $105 in cash for each $100 face value, or (2) $5 in cash per $100 face value, and a new bond of the same amount as the old, but bearing a lower rate of interest and maturing 25 years after issue. The holders of $600,000 face amount of old bonds elected to be paid in cash, receiving $630,000. The holders of $1,400,000 elected to exchange. They received $70,000 in cash. The expenses of the redemption and conversion were $10,500.

X Corporation keeps its accounts on the accrual basis. How should these transactions be reflected on its income tax return for 1954?

INSTALLMENT SALES

Section 453 of the 1954 Code allows the income from certain installment sales to be returned ratably over the period within which the payments are received. This applies to dealers in personal property, and to sales of real property and to sales of personal property for a price exceeding $1,000, if the initial "pay-

ments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 per cent of the selling price." [1]

Note the provision in sec. 453(d) requiring the payment of tax on any outstanding income on the "disposition" of an installment obligation. It was held under the prior law that this provision applied in the case of the death of the holder of the installment obligation. *Crane v. Helvering*, 76 F.2d 99 (C.C.A.2d, 1935); *Goldberg v. Commissioner*, 189 F.2d 634 (C.A.2d, 1951). But cf. Rev.Rul. 267, 1953–2 Cum.Bull. 32 (succession on death of a joint tenant not a "transmission"). This matter is now covered by sec. 691(a)(4), which brings the rule as to installment sale income passing at death within the general rule for income in respect of decedents.

Notes

(A) The installment basis is not a complete method of accounting but only a method of reporting the income from sales made on the installment plan. In Rev.Rul. 54–111, 1954–1 Cum. Bull. 76, the Treasury ruled as follows: "It is held that a regular dealer in personal property may elect to report income from installment sales on the installment basis and continue to report income from sales on open account on the accrual basis." See also Mero, "The Installment Basis for Dealers in Personal Property," 37 Taxes 985 (1959).

(B) The installment basis may be useful to writers, who may prefer this method to that made available by sec. 1302 of the 1954 Code. Under this plan, the writer agrees to sell his manuscript to a publisher, and receives $20x on completion of the manuscript, and $25x for each of the next four years. In Rev. Rul. 234, 1953–2 Cum.Bull. 29, the Commissioner ruled that this was an installment sale, completed when the manuscript is turned over to the publisher, but with the payments taxable over the years as received.

LONG TERM CONTRACTS OR COMPLETED CONTRACTS

Another method of reporting income is applicable to long term contracts, sometimes called the completed contract method. It is not spelled out in the statute but has long been authorized by the Regulations. See sec. 1.451–3 of the Income Tax Regulations. It allows the return of income (a) ratably over the period of the contract instead of at the time the payments are actually received, or (b) on the completion of the contract. This provision of the regulation should be carefully examined.

In *E. E. Black, Ltd. v. Alsup*, 211 F.2d 879 (C.A.9th, 1954), the taxpayer was a building contractor, using the completed con-

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[1] See Mero, "The Installment Basis for Dealers in Personal Property," 25 Taxes 223 (1947); Mero, "Unrealized Gross Profit of Installment Dealers," 27 Taxes 521 (1949); Lourie and Cutler, "Capital Assets Sold on the Installment Basis," 26 Taxes 707 (1948).

tract basis. It built a housing project, and in 1945 received all but $533.50 of the contract price. This amount was withheld until the completion of the installation of thermostats in the fire alarm system. Installation was complete in March, 1946, and final payment was made in June, 1946.

The taxpayer reported all of the profit in 1946 (when there was no excess profits tax). The Commissioner ruled that the profit was taxable in 1945, saying that the phrase "finally completed and accepted" in the Regulations meant substantially completed. The court held that the profit was taxable in 1946, saying that "the Regulation should be taken as meaning what it plainly says." [1]

Similarly, in *E. Turgeon Construction Co.,* T. C. Memo., Jan. 27, 1960, it was held that interest paid on a loan incurred in connection with a construction contract was deductible in full in the year in which the contract was completed. The Commissioner's contention that it should be deducted as accrued over a period of three years was rejected.

INVENTORIES

When a manufacturer or retailer sells goods, the amount received is ordinarily readily ascertainable. However, this amount is not gross income, for the cost of goods sold must be restored before there is gross income. This may be represented by:

$$(1) \qquad GI = GR - CGS$$

where GI is gross income, GR is gross receipts, and CGS is cost of goods sold.

The problem then is to find the cost of goods sold. In some cases (as, say, a dealer in automobiles), it may be possible to tell the exact cost of each item sold. Generally, however as in the case of a manufacturer or a department store, it is not feasible or possible to keep track of the exact cost of each specific item sold. Moreover, there may be fluctuations in value of items on hand, even when they can be identified, which may affect the computation. The method which has been developed for dealing with this problem is the use of inventories.[1]

We seek the cost of goods sold during the accounting period. The stock of goods from which sales have been made is made up of two items: (1) the goods on hand at the beginning of the period, and (2) those purchased during the period. If we subtract

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[1] See "Deferral of Income under the Completed Contract Method of Tax Accounting," 64 Yale L.J. 448 (1954); Wagman, "Tax Accounting for Long-Term Contracts," 33 Taxes 277 (1955); Herwitz, "Accounting for Long-Term Construction Contracts," 70 Harv.L.Rev. 449 (1957).

[1] See, generally, Ballantine, "Inventories," in The Federal Income Tax 160 (Columbia University, 1921).

(3) the goods on hand at the end of the period, we have a measure of those sold during the period. This may be represented by the following:

$$(2) \qquad CGS = I_O + P - I_C$$

where I_O is the opening inventory P is the cost of purchases during the period, and I_C is the closing inventory.

Substituting equation (2) in equation (1), we have:

$$(3) \qquad GI = GR - (I_O + P - I_C)$$

or

$$(4) \qquad GI = GR - I_O - P + I_C$$

From this, it directly appears that gross income is *reduced* as the opening inventory is increased, and is *increased* through any increase in the closing inventory. But the closing inventory of one year is the opening inventory of the following year. Thus any change in the closing inventory of one year affects the income of that year, and also has precisely the opposite effect on the income of the next year. Inventory adjustments consequently become a means of allocating income to one year or another.

The difficulties arise in valuing the inventory.[2] By a process of counting or measuring or weighing, it is ordinarily fairly easy to determine the number of units in the inventory at any given time. But tax computations must be made in dollars, and to put the inventory into dollars requires assigning a value in dollars or cents to each unit in the inventory. What value should be used? It might be a figure based upon cost; or it might be a figure based upon market value at the time the inventory is taken. If the market price has been going up, an inventory valued at market would include in income the unrealized increase in market value of the goods still on hand. On the other hand, where the market value has gone down, an inventory valuation based on market will reduce the income for the year by the unrealized loss in market value of the goods still on hand. There are no rigid rules here, except that the method used must be used consistently year after year. Any practice adopted is simply a convention. Long before the income tax entered the picture, it had become conservative accounting practice in many industries to value inventories at "cost or market, whichever is lower." On this basis, you will note, decreases in market value will lower the inventory figure, and thus reduce income for the year, even though the goods have not been sold, and the inventory loss may in fact never be realized.

If the inventory is based upon "cost," it is obviously necessary to determine cost. This is equally true, when the inventory is valued at "cost or market, whichever is lower"; for it cannot be

[2] Johnson, "Problems Involved in Valuing Inventories," 36 Taxes 866 (1958).

told which is lower until cost is determined and compared with the market value. The determination of cost presents another problem, since ordinarily the actual cost of the items on hand at the close of the period cannot be told. Consider, for example, the hardware dealer who sells nails at retail and keeps his stock in a barrel. As customers come to the store, he scoops out nails, weighs them, and includes the sales price in his gross receipts. When the supply of nails in the barrel runs low, he orders new ones, and dumps them into the barrel when they come, usually on top of those which are already there. Sometimes he may get to the very bottom of the barrel. Other times, he may replenish the supply when the barrel is half or a quarter full. It is obviously impossible or impracticable to mark or identify the nails so as to show when any particular nails were bought or the price which was paid for them.

Some convention must be adopted, and for many years the only method allowed for tax purposes was "first in, first out," sometimes abbreviated as FIFO. This may be illustrated as follows. Let us suppose that we have these facts:

Opening inventory		50 units valued (on some basis)	@ 10 per unit
Purchases:	Jan.	10 units	@ 9 cost (determined from invoices)
	Feb.	12	@ 10
	Mar.	8	@ 11
	Apr.	12	@ 10
	May	14	@ 11
	June	10	@ 12
	July	12	@ 12
	Aug.	13	@ 13
	Sept.	14	@ 12
	Oct.	8	@ 13
	Nov.	11	@ 14
	Dec.	12	@ 15
Closing inventory		64 units	

On a first in, first out basis, the items on hand at the beginning of the year, and those earliest bought, would be the first to go. Those remaining at the end of the year would be those most recently purchased—first in, first out is the equivalent of last in, last out. Thus, the closing inventory of 64 units would be treated as made up of those most recently purchased, going back as far as necessary until the total of 64 units was made up. On the facts given this would take in all of those bought in December, November, October, September, August, and 6 of those bought in July. Thus the closing inventory would be:

July	6 units	@ 12	72
Aug.	13	@ 13	169
Sept.	14	@ 12	168
Oct.	8	@ 13	104
Nov.	11	@ 14	154
Dec.	12	@ 15	180
Total	64		847

Note that prices were generally rising during the year in question, and the effect of using the FIFO convention is that the increase in cost during the year is reflected in the closing inventory and thus directly in the gross income taxable for the year. And this is true, even though the nails actually on hand are those at the bottom of the barrel which have been there for many years.

The original provision in the statute with respect to inventories is now found in sec. 471 of the 1954 Code. It is very brief, and very sketchy. See also the corresponding provision of the Regulations. Sec. 39.22(c)–2 of Regulations 118 prescribes the "first in, first out" method of inventory valuation, and this has been upheld by the courts.

Many businesses, however, have felt that this method was unsound. Consider, for example, a pipe line company which has to have a large quantity of oil in its pipe line just to keep operating. Although this oil is constantly changing, the company has to keep oil on hand to keep the pipe line filled; it cannot operate without it. The oil is really as much a part of its equipment as the pipe or the pumps. We would not take into account (in computing annual income) fluctuations in the value of the pipes or pumps or storage tanks. Why should fluctuations in the value of the oil in the pipe line be reflected in gross income? Or consider a tobacco company which has to keep three years' supply of tobacco in storage as long as it plans to keep on operating—or a meat packing company, where the average interval between the time when animals enter the plant and the time the finished products are sold and delivered is said to be three months.[3]

In 1939 Congress first enacted the so-called optional method of inventory valuation, and this is now set out in detail in sec. 472 of the 1954 Code. It authorizes the "last in, first out" method of inventory valuation, or LIFO. Under this method, the convention to be used in valuing the closing inventory at cost is just reversed; it is assumed that the items on hand at the close of the year are those bought longest ago. "Last in, first out" is the equivalent of "first in, last out." Thus on the basis of the example set out above, if LIFO were used, the closing inventory of 64 units would be made up of those earliest acquired. These would be the 50 units on hand at the beginning of the year, plus the ten acquired in January, and 4 of those acquired in February. This may be tabulated as follows:

Opening inventory	50 units	@ 10	500
Jan.	10	@ 9	90
Feb.	4	@ 10	40
Total	64		630

3 Cf. Bliss, "The Reality of Inventory Profits," 26 Harv.Bus.Rev. 527 (1948).

Thus the closing inventory on LIFO is 630, while we have ascertained that on FIFO the closing inventory is 847. A substantial difference in the amount of taxable income for the year depends simply on the method of inventory valuation which is used. The use of FIFO will mean that both increases and decreases in the market value of items in the inventory will be reflected in income; while under LIFO neither increases nor decreases in market value will be reflected with respect to the number of units which have been on hand throughout the period. (Note that if, in the example, the closing inventory had been less than 50 units, it would have been necessary to analyze it, and to determine the cost of the number of units in the closing inventory which had been earliest acquired.)

For an excellent discussion of the general problem, see "Base Stock Inventories and Federal Income Taxation," 51 Harv.L. Rev. 1430.[4]

LIFO can be regarded as a sort of averaging device. From the beginning to the end of a complete operation, both FIFO and LIFO will necessarily produce exactly the same aggregate net income. But FIFO will produce more fluctuations. Inventories will go up when prices go up, and inventories will go down when prices go down, with corresponding effects on taxable income. Under LIFO, fluctuations in value of a more or less permanent inventory—the amount of goods the business has to have on hand if it is to keep operating—will not enter into the income computation as long as the volume of goods on hand does not fall below the basic figure.[5]

In *Hutzler Brothers Co.*, 8 T.C. 14 (1947), the Tax Court held that a taxpayer reporting inventory on the retail method was entitled to elect to use the last-in first-out method. This is an important decision, containing a remarkably clear discussion of the whole problem of inventories in retail stores, and the methods of applying the last-in first-out procedure to such inventories, in-

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[4] See also Hoffman, "Tax Shortcomings in the Lifo Provisions," 31 Taxes 407 (1953); Moonitz, "The Case against LIFO," 95 J. of Accountancy 682 (1953); McAuly, "The Case for LIFO," 95 J. of Accountancy 691 (1953); Pelt, "Reasons for Encouraging Broader Utilization of LIFO," 96 J. of Accountancy 452 (1953); Butters, Effects of Taxation—Inventory Accounting and Policies (1949); "The Last-In, First-Out, Inventory Basis," a report of a Committee of the American Institute of Accountants, 73 J. of Accountancy 146 (1942); Davis, "Some Problems of Last-in, First-out Accounting," 17 Accounting Rev. 384 (1942); Paton, "Last In, First Out," 69 J. of Accountancy 354 (1940); Arthur, "Inventory Profits in the Business Cycle," 28 Am.Econ. Rev. 27 (1938); Walker, "The Base-Stock Principle in Income Accounting," 15 Harv.Bus.Rev. 76 (1936).

[5] But cf. Eldridge, "Issues Raised by Proposal to Grant Cost or Market Option with LIFO," 6 Nat.Tax J. 521 (1953).

volving the use of price index numbers. There is a good comment on the *Hutzler* case in 20 So.Calif.Rev. 386 (1947).[6]

The Treasury has accepted this in the Regulations. See sec. 1.472–1(k) and (*l*) of The Income Tax Regulations.

IMPROVEMENTS BY LESSEES

Helvering v. Bruun, 309 U.S. 461 (1940), involved a lessor who leased Blackacre to a tenant who thereafter erected a building on the land. Later, the tenant was unable to pay the rent, the lease terminated, and the lessor reacquired the land with the building on it. It was held that the fair market value of the building was taxable as income in the year of reacquisition.

This result was changed in 1942, when the provision now found in sec. 109 of the 1954 Code was added to the statute. See also the provision as to basis in sec. 1019 of the 1954 Code, which is correlative to sec. 109.

Note

Cf. I.T. 4009, 1950–1 Cum.Bull. 13, where a tract of land was rented for five years. Under the terms of the lease, the lessee paid no rent but he did agree to install improvements with a useful life much longer than the term of the lease. It was ruled that the fair market value of the improvements, subject to the lease, were rent and were taxable to the lessor as income in the year when they were installed.

BARGAIN PURCHASES

ROSE v. TRUST CO. OF GEORGIA

United States Circuit Court of Appeals, Fifth Circuit, 1928, 28 F.2d 767.

FOSTER, CIRCUIT JUDGE. This is a suit to recover $199,764.84, alleged to have been improperly collected from appellee by appellant as income taxes for the year 1919. The jury was waived, and a judgment was entered by the District Court in favor of appellee for $199,258.53, with interest at 6 per cent. per annum from March 10, 1924. There is no dispute as to the facts. Those material to a decision are as follows:

In August, 1919, a syndicate, of which appellee was a member, was formed for the purpose of reorganizing the Coca-Cola Company of Georgia. Another company of the same name was incorporated under the law of Delaware, with a capital stock of 100,000 shares of preferred stock, of the par value of $100, and

6 See also Roeder, "The Hutzler Case: LIFO and the Retail Merchant," 7 N.Y.U.Inst.Fed.Taxation 74 (1949); "Accounting Research Bulletin Number 29: Inventory Pricing," 84 J. of Accountancy 196 (1947); Crown, "Inventory Pricing," 26 Taxes 318 (1948). See, generally, Sweeney, "Mercantile Inventory Treatment for Income Tax Purposes," 14 U. of Pitts.L.Rev. 538 (1953).

500,000 shares of common stock, with no par value. The syndicate agreed to purchase 83,000 shares of the common stock at $5 per share and to underwrite the remaining 417,000 shares of common stock for sale to the public at $35 per share. The common stock was oversubscribed and was sold to the public at $40 and the syndicate received and paid for the stock it had agreed to purchase. The assets of the Coca-Cola Company of Georgia were transferred to the Coca-Cola Company of Delaware in exchange for the 100,000 shares of preferred stock and $15,000,000 in cash. These assets consisted of physical property worth about $5,000,000, and the trade-mark and formula of Coca-Cola, together with the good will of the company. After it was put on the market, the common stock fell as low as $18 a share, but has since advanced greatly above the original price of $40.

Appellee received 13,677 shares of common stock at $5 per share as its portion, and on this transaction the Commissioner assessed income taxes based on an estimated profit of $35 per share. This stock was initially deposited with a trustee in a voting trust to run for five years. Subsequently 3,000 shares were sold, and the tax based on actual profit accounted for. The Commissioner, in assessing the tax, proceeded on the theory that the $5 per share paid by appellee was a nominal price, that the stock was really transferred as compensation for personal services in organizing the new corporation, and that a taxable profit was derived from the transaction in the difference between the amount paid and the market value at the time of transfer. The District Court held against this contention and reached the conclusion that appellee in good faith had purchased the stock; that the $5 per share paid was a capital investment; and that no profit had been derived, as the stock had not been disposed of in any manner, or its increase in value realized. To this error is assigned.

Conceding that compensation for personal services may be paid in property, instead of in money, and that income taxes may be assessed on the value of the property, we agree with the District Court that the transaction here in question was a purchase in good faith. In such case no taxable income would be derived until the disposal of the stock, except, of course, that arising from dividends. *Eisner v. Macomber,* 252 U.S. 189; *McCaughn v. Ludington,* 268 U.S. 106.

Other questions are raised by appellant, but they are immaterial, and need not be discussed.

Affirmed.

Notes

(A) Is this result sound? Would the case be followed today?

(B) A corporation authorizes the sale of property to its shareholders for less than its actual value. Does this constitute a divi-

dend to the shareholders? Earlier cases held that it did not. See *Commissioner v. Van Vorst,* 59 F.2d 677 (C.C.A.9th, 1932). But later cases reached the contrary conclusion. See *Timberlake v. Commissioner,* 132 F.2d 259 (C.C.A.4th, 1942). And the provision of the regulation is clear. See sec. 1.301–1(j) of the Income Tax Regulations.

(C) A life insurance agent writes a policy on his own life, paying the company the standard rate less his regular commission. Does he derive income from the transaction? See G.C.M. 10486, XI–1 C.B. 14 (1932). See also Rev.Rul. 55–273, 1955–1 Cum.Bull.

In *Ostheimer v. United States,* 264 F.2d 789 (C.A.3d, 1959), cert. den. 361 U.S. 818 (1959), it was held that a life insurance agent was taxable on commissions on policies on the lives of his partner, key employees and children. See also *Commissioner v. Minzer,* ––– F.2d ––– (C.A.5th, 1960), reversing *Sol Minzer,* 31 T.C. 1130 (1959), which was noted in 45 Va.L.Rev. 748 (1959). *Kenneth W. Daehler,* 31 T.C. 722 (1959), involved the same question with regard to a real estate salesman's individual purchase of property, and held there was no tax on the commission saved. There is a comment on the *Daehler* case in 1959 Duke L.J. 476.

(D) The taxpayer was a member of a syndicate which underwrote an offering of common stock at $40 a share, to be offered to the public on October 14, 1929. During the offering period, the stock declined on the market to $14 a share. A few days later, when the stock was worth $18 a share on the market, the taxpayer was forced to take up the 18,730 shares he had underwritten at the $40 price. He did not sell the shares during the taxable year. Did he have a deductible loss on the transaction? *Grigsby v. Commissioner,* 87 F.2d 96 (C.C.A.7th, 1937), cert. den. 301 U.S. 690 (1937).

Stock Options

COMMISSIONER v. LO BUE

Supreme Court of the United States, 1956. 351 U.S. 243.

MR. JUSTICE BLACK delivered the opinion of the Court.

This case involves the federal income tax liability of respondent LoBue for the years 1946 and 1947. From 1941 to 1947 LoBue was manager of the New York Sales Division of the Michigan Chemical Corporation, a producer and distributor of chemical supplies. In 1944 the company adopted a stock option plan making 10,000 shares of its common stock available for distribution to key employees at $5 per share over a 3-year period. LoBue and a number of other employees were notified that they had been tentatively chosen to be recipients of nontransferable stock options contingent upon their continued employment. LoBue's notice told him: "You may be assigned a greater or lesser amount of stock based entirely upon your individual results and that of the entire organization." About 6 months later he was

notified that he had been definitely awarded an option to buy 150 shares of stock in recognition of his "contribution and efforts in making the operation of the company successful." As to future allotments he was told "It is up to you to justify your participation in the plan during the next two years."

LoBue's work was so satisfactory that the company in the course of 3 years delivered to him 3 stock options covering 340 shares. He exercised all these $5 per share options in 1946 and in 1947,[1] paying the company only $1,700 for stock having a market value when delivered of $9,930. Thus, at the end of these transactions, LoBue's employer was worth $8,230 less to its stockholders and LoBue was worth $8,230 more than before.[2] The company deducted this sum as an expense in its 1946 and 1947 tax returns but LoBue did not report any part of it as income. Viewing the gain to LoBue as compensation for personal services the Commissioner levied a deficiency assessment against him, relying on § 22(a) of the Internal Revenue Code of 1939, 53 Stat. 9, which defines gross income as including "gains, profits, and income derived from . . . compensation for personal service . . . of whatever kind and in whatever form paid . . . ."

LoBue petitioned the Tax Court to redetermine the deficiency, urging that "The said options were not intended by the Corporation or the petitioner to constitute additional compensation but were granted to permit the petitioner to acquire a proprietary interest in the Corporation and to provide him with the interest in the successful operation of the Corporation deriving from an ownership interest." The Tax Court held that LoBue had a taxable gain if the options were intended as compensation but not if the options were designed to provide him with "a proprietary interest in the business." Finding after hearings that the options were granted to give LoBue "a proprietary interest in the Corporation, and not as compensation for services" the Tax Court held for LoBue. 22 T.C. 444. Relying on this finding the Court of Appeals affirmed, saying: "This was a factual issue which it was the peculiar responsibility of the Tax Court to resolve. From our examination of the evidence we cannot say that its finding was clearly erroneous." 223 F.2d 367. Disputes over the taxability of stock option transactions

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[1] There may be some question as to whether the first option was exercised in 1945 or 1946. See the discussion, infra, as to when the transactions were completed.

[2] The Commissioner assessed a deficiency on the basis of $8,680 although the record figures show a difference between option price and market value of $8,230. No explanation for the discrepancy appears in the record.

such as this are longstanding.[3] We granted certiorari to consider whether the Tax Court and the Court of Appeals had given § 22(a) too narrow an interpretation. 350 U.S. 893.

We have repeatedly held that in defining "gross income" as broadly as it did in § 22(a) Congress intended to "tax all gains except those specifically exempted." See, *e. g., Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 429–430. The only exemption Congress provided from this very comprehensive definition of taxable income that could possibly have application here is the gift exemption of § 22(b)(3). But there was not the slightest indication of the kind of detached and disinterested generosity which might evidence a "gift" in the statutory sense. These transfers of stock bore none of the earmarks of a gift. They were made by a company engaged in operating a business for profit, and the Tax Court found that the stock option plan was designed to achieve more profitable operations by providing the employees "with an incentive to promote the growth of the company by permitting them to participate in its success." 22 T.C., at 445. Under these circumstances the Tax Court and the Court of Appeals properly refrained from treating this transfer as a gift. The company was not giving something away for nothing.[4]

Since the employer's transfer of stock to its employee LoBue for much less than the stock's value was not a gift, it seems impossible to say that it was not compensation. The Tax Court held there was no taxable income, however, on the ground that one purpose of the employer was to confer a "proprietary interest." [5] But there is not a word in § 22(a) which indicates that its broad coverage should be narrowed because of an employer's intention to enlist more efficient service from his employees by making them part proprietors of his business. In our view there is no statutory basis for the test established by the courts below. When assets are transferred by an employer to an employee to secure better services they are plainly compensation. It makes no difference that the compensation is paid in stock rather than in money. Section 22(a) taxes income derived from compensation "in whatever form paid." And in

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3 See, e. g., Durkee v. Welch, 49 F.2d 339; Erskine v. Commissioner, 26 B.T.A. 147; Geeseman v. Commissioner, 38 B.T.A. 258; Evans v. Commissioner, 38 B.T.A. 1406. See also Miller, The Treasury's Proposal to Tax Employees' Bargain Purchases, 56 Yale L.J. 706; Note, 64 Yale L.J. 269; 93 Cong.Rec. A4060–A4066; Surrey and Warren, Federal Income Taxation (1955 ed.), 653–674.

4 Robertson v. United States, 343 U.S. 711, 713–714; Bogardus v. Commissioner, 302 U.S. 34.

5 The Tax Court noted "that in practically all such cases as the one before us, both the element of additional compensation and the granting of a proprietary interest are present." 22 T.C., at 445. See also Commissioner v. Geeseman, 38 B.T.A. 258, 263.

another stock option case we said that § 22(a) "is broad enough to include in taxable income any economic or financial benefits conferred on the employee as compensation, whatever the form or mode by which it is effected." *Commissioner v. Smith,* 324 U.S. 177, 181. LoBue received a very substantial economic and financial benefit from his employer prompted by the employer's desire to get better work from him. This is "compensation for personal service" within the meaning of § 22(a).

LoBue nonetheless argues that we should treat this transaction as a mere purchase of a proprietary interest on which no taxable gain was "realized" in the year of purchase. It is true that our taxing system has ordinarily treated an arm's length purchase of property even at a bargain price as giving rise to no taxable gain in the year of purchase. See *Palmer v. Commissioner,* 302 U.S. 63, 69. But that is not to say that when a transfer which is in reality compensation is given the form of a purchase the Government cannot tax the gain under § 22(a). The transaction here was unlike a mere purchase. It was not an arm's length transaction between strangers. Instead it was an arrangement by which an employer transferred valuable property to his employees in recognition of their services. We hold that LoBue realized taxable gain when he purchased the stock.[6]

A question remains as to the time when the gain on the shares should be measured. LoBue gave his employer promissory notes for the option price of the first 300 shares but the shares were not delivered until the notes were paid in cash.[7] The market value of the shares was lower when the notes were given than when the cash was paid. The Commissioner measured the taxable gain by the market value of the shares when the cash was paid. LoBue contends that this was wrong, and that the gain should be measured either when the options were granted or when the notes were given.

It is of course possible for the recipient of a stock option to realize an immediate taxable gain. See *Commissioner v. Smith,* 324 U.S. 177, 181–182. The option might have a readily ascertainable market value and the recipient might be free to sell his option. But this is not such a case. These three options were

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[6] Since our view of the statute requires taxation of gain here it is unnecessary for us to rely on the Treasury Regulations to reach that conclusion. Apparently the present regulations were not applicable to all of the options. See 26 CFR § 39.22(a)(1)(c); 1939–1 Cum.Bull. 159; 1946–1 Cum.Bull. 15–18. And since the transactions in question here occurred prior to 1950 the 1950 statute establishing special tax treatment for "restricted stock option plans" has no relevance. See § 130A, Internal Revenue Code of 1939, 64 Stat. 942. And see § 421, Internal Revenue Code of 1954.

[7] LoBue paid cash for the last 40 shares.

not transferable[8] and LoBue's right to buy stock under them was contingent upon his remaining an employee of the company until they were exercised. Moreover, the uniform Treasury practice since 1923 has been to measure the compensation to employees given stock options subject to contingencies of this sort by the difference between the option price and the market value of the shares at the time the option is exercised.[9] We relied in part upon this practice in *Commissioner v. Smith,* 324 U.S. 177, 324 U.S. 695. And in its 1950 Act affording limited tax benefits for "restricted stock option plans" Congress adopted the same kind of standard for measurement of gains. § 130A, Internal Revenue Code of 1939, 64 Stat. 942. And see § 421, Internal Revenue Code of 1954. Under these circumstances there is no reason for departing from the Treasury practice. The taxable gain to LoBue should be measured as of the time the options were exercised and not the time they were granted.

It is possible that a bona fide delivery of a binding promissory note could mark the completion of the stock purchase and that gain should be measured as of that date. Since neither the Tax Court nor the Court of Appeals passed on this question the judgment is reversed and the case is remanded to the Court of Appeals with instructions to remand the case to the Tax Court for further proceedings.

Reversed and remanded.

MR. JUSTICE FRANKFURTER and MR. JUSTICE CLARK, concurring.

We join in the judgment of the Court and in its opinion on the main issue. However, the time when LoBue acquired the interest on which he is taxed was not in issue either before the Tax Court or the Court of Appeals. In the circumstances of this case there certainly is no reason for departing from the general rule whereby this Court abstains from passing on such an issue in a tax case when raised here for the first time. See *Helvering v. Minnesota Tea Co.,* 296 U.S. 378, 380; *Helvering v. Tex-Penn Co.,* 300 U.S. 481, 498.

MR. JUSTICE HARLAN, whom MR. JUSTICE BURTON joins, concurring in part and dissenting in part.

In my view, the taxable event was the grant of each option, not its exercise. When the respondent received an unconditional option to buy stock at less than the market price, he received

8 Cf. McNamara v. Commissioner, 210 F.2d 505.

9 See 1923 II-1 Cum.Bull. 50; 1939-1 Cum.Bull. 159; 1946-1 Cum.Bull. 15-18; Dillavou, Employee Stock Options, 20 Accounting Review 320; Miller, The Treasury's Proposal to Tax Employee's Bargain Purchases, 56 Yale L.J. 706, 713-715. See also Note, The Valuation of Option Stock Subject to Repurchase Options and Restraints on Sales, 62 Yale L.J. 832; Note, Tax Effects of Absence of Market Value on Employee Bargain Purchases, 21 U. of Chi.L. Rev. 464.

an asset of substantial and immediately realizable value, at least equal to the then-existing spread between the option price and the market price. It was at that time that the corporation conferred a benefit upon him. At the exercise of the option, the corporation "gave" the respondent nothing; it simply satisfied a previously-created legal obligation. That transaction, by which the respondent merely converted his asset from an option into stock, should be of no consequence for tax purposes. The option should be taxable as income when given, and any subsequent gain through appreciation of the stock, whether realized by sale of the option, if transferable, or by sale of the stock acquired by its exercise, is attributable to the sale of a capital asset and, if the other requirements are satisfied, should be taxed as a capital gain.[1] Any other result makes the division of the total gains between ordinary income (compensation) and capital gain (sale of an asset) dependent solely upon the fortuitous circumstance of when the employee exercises his option.[2]

The last two options granted to respondent were unconditional and immediately exercisable, and thus present no further problems. The first option, however, was granted under somewhat different circumstances. Respondent was notified in January 1945, that 150 shares had been "allotted" to him, but he was given no right to purchase them until June 30, 1945, and his right to do so then was expressly made contingent upon his

1 Commissioner v. Smith, 324 U.S. 177, 324 U.S. 695, does not require an opposite result. In that case Smith's employer, Western, had undertaken the management of a reorganized corporation, Hawley, under a contract by which Western was to receive as compensation for its managerial services a specified amount of stock in Hawley if it was successful in reducing Hawley's indebtedness by a stated amount. Western, in turn, gave Smith, who was active in the Hawley reorganization, an option to buy, at the then-existing market price, a fixed share of any Hawley stock received under the management contract. The management contract was successfully performed, and a part of the Hawley stock received by Western—the value of which was of course substantially enhanced by the performance of the contract—was sold to Smith at the option price. Under the peculiar facts of that case—more analogous to an assignment to an employee of a share in the anticipated proceeds of a contract than to the usual employee stock option plan—the Tax Court's finding that the gain that would accrue to Smith upon the successful performance of the management contract was intended as "compensation" to him for his services was no doubt amply justified. But as the Court expressly stated in upholding that finding: "It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation." Id., at p. 182.

2 Suppose two employees are given unconditional options to buy stock at $5, the current market value. The first exercises the option immediately and sells the stock a year later at $15. The second holds the option for a year, exercises it, and sells the stock immediately at $15. Admittedly the $10 gain would be taxed to the first as capital gain; under the Court's view, it would be taxed to the second as ordinary income because it is "compensation" for services. I fail to see how the gain can be any more "compensation" to one than it is to the other.

still being employed at that date. His right to purchase the first allotment of stock was thus not vested until he satisfied the stated condition, and it was not until then that he could be said to have received income, the measure of which should be the value of the option on that date.

Accordingly, while I concur in the reversal of the judgment below and in the remand to the Tax Court, I would hold the granting of the options to be the taxable events and would measure the income by the value of the options when granted.

Note

Neither the *LoBue* case nor its predecessors make it very clear just *when* the income is derived from a stock option. Is it: (1) when the option is granted, (2) when the option is exercised, (3) when the money is paid, or (4) when the stock is received?

If the option is freely transferable and marketable, it may be that income is derived when the option is granted. This may be implied in the *LoBue* decision. The chief problems arise when the option has conditions, such as continued employment by the grantor of the option.

On remand, the Tax Court in the *LoBue* case held that the relevant date is when the option is exercised, even though payment was made at that time by a note. *Philip J. LoBue,* 28 T.C. 1317 (1958). This was affirmed by the Court of Appeals. *Commissioner v. LoBue,* 256 F.2d 735 (C.A.3d, 1958). See also *Commissioner v. Estate of Ogsbury,* 258 F.2d 294 (C.A.2d, 1958).

In 1950 Congress added the provision now found in sec. 421 of the 1954 Code giving special treatment to "restricted stock options." The provision is an elaborate one. Though it contains certain safeguards and restrictions which limit its scope somewhat, it would appear to be a substantial loophole in the tax law. Regulations have been issued under sec. 421 of the 1954 Code as sec. 1.421–1 through 1.421–6 of the Income Tax Regulations.

Despite recognition of the legitimate place of incentives, and the desirability of having corporate officers have an interest in the stock of their companies, it is difficult to see why this particular group of taxpayers should be able to get a substantial portion of their compensation at capital gain rates while others pay at the ordinary income rates. If current tax rates are too high for corporate executives they are too high for all; if they cannot be lower for all taxpayers, they should not be lowered for a single class. Perhaps the solution is to provide that all income shall be taxed as long term capital gain!

The new provision is applicable only to options granted to employees. The option price must be at least 85% of the fair mar-

ket value at the time the option is granted. The stock must be held for at least six months after the exercise of the option, and until at least two years after the granting of the option. If all of these requirements are met, then no income results to the individual at the time of exercise of the option, and eventual gain on sale is taxable as capital gain. There are other provisions and details which must be examined in the statute.

Notes

(A) Consider the problem from the point of view of the corporation. If a corporation allows an employee to buy for $100 a share of stock worth $150, may the corporation deduct the $50 difference as compensation for services? See *Lowry v. Consolidated African Selection Trust,* [1940] 2 All Eng.L.R. 545, noted in 56 L.Q.Rev. 453 (1940), and in 54 Harv.L.Rev. 510 (1941).

Note that where an option is granted within sec. 421 of the 1954 Code, the corporation gets no deduction. Sec. 421(a). Thus the extra compensation granted to the executive is doubly at the cost of the shareholders.

(B) For general discussion, see Schlesinger, "Selected Problems in the Use of Restricted Stock Options," 36 Taxes 709 (1958); Mills, "Recent Developments in the Taxation of Executive Compensation," 34 Taxes 882 (1956); Chapman and Mason, "Recent Legislative Developments in Capital Gains and Losses," 42 Cornell L.Q. 138, 160–166 (1957).

See also Griswold, "The Mysterious Stock Option," in 2 Tax Revision Compendium (Ways and Means Committee, 1959) 1327.

Reference should again be made to the provisions in the statute for pension and profit-sharing plans (see secs. 401–404 of the 1954 Code, discussed at p. 459 above). Between these and the special provisions for stock options, it is possible to provide a large amount of income for corporate executives without current tax, and with eventual tax at capital gain rates. When various "fringe benefits" are also considered, it is obvious that this is an area in which the high surtax rates are not as fearsome in their application as they would appear to be when read. See Rudick, "Compensation of Executives under the 1954 Code," 33 Taxes 7 (1955).[1]

Suppose an option is given to an employee which does not qualify under sec. 421. In *McNamara v. Commissioner,* 210 F.2d 505 (C.A.7th, 1954), it was held that the value of the option when received was taxable income. When the employee thereafter exercised the option, there were no tax consequences. Presumably

[1] See also Miller, "Capital Gains Taxation of the Fruits of Personal Effort: Before and under the 1954 Code," 64 Yale L.J. 1 (1954).

he will have capital gain when he sells the stock. The court distinguished *Commissioner v. Smith,* 324 U.S. 177 (1945), case because there the option had no value when given, and the intended compensation was found to be present at the time of the exercise of the option.

In *Commissioner v. Stone's Estate,* 210 F.2d 33 (C.A.3d, 1954), the taxpayer purchased stock warrants from his employer for less than their fair market value. He included the difference as income in his tax return. In a subsequent year he sold the warrants at a large gain. It was held that this was long term capital gain.

There is a comment on these cases in 64 Yale L.J. 269 (1954).[2]

These questions are now affected by the provisions of sec. 1.-421–6 of the Income Tax Regulations, relating to options to which sec. 421 of the Code does not apply. This provides that where an option is exercised and at that time the stock received "is subject to a restriction which has a significant effect on its value," then no income is realized until "such restriction lapses or at the time such property is sold or exchanged." Such a restriction might be an obligation to sell the stock to the corporation at book value as long as he remained in its employ, or until his death. On this basis, it may well be that non-restricted stock options—which can be issued at deep discounts—will be more attractive than restricted options under sec. 421 of the Code. See Pomeroy, "Nonrestricted Stock Options and The New Regulations," 38 Taxes 387 (1960).

[2] See also Edwards, "Executive Compensation: The Taxation of Stock Options," 13 Vanderbilt L.Rev. 475 (1960); Rhodes, "Unrestricted Stock Options," 11 Southwestern L.J. 39 (1957); Smith, "Executive Stock Options—Alternatives to the Proprietary Option Doctrine," 11 Southwestern L.J. 70 (1957); "Taxation of Restricted Executive Stock Options Which Do Not Qualify Under Section 421(a) of the 1954 Code," 51 Northwestern U.L.Rev. 621 (1956).

CHAPTER 8

CAPITAL GAINS AND LOSSES

Secs. 1001–1231 of the 1954 Code [1]

Regulations have been issued under most of the sections of the Code dealing with Capital Gains and Losses. These may be found by looking for the correspondingly numbered provision in the Income Tax Regulations.

For some time there was uncertainty whether the power granted to Congress by the Sixteenth Amendment to tax "incomes" without apportionment was broad enough to authorize a tax on gains derived on the sale of property, or capital gains. The constitutional question was settled in favor of the power to tax by *Merchants Loan & Trust Co. v. Smietanka,* 255 U.S. 509 (1921). But, though the power is established, many questions remain.

A. Should Capital Gains be Taxed?

A good many suggestions are made, particularly on the financial pages, to the effect that capital gains should not be taxed. The arguments vary all the way from a dogmatic assertion that capital gains are not in the nature of things income, to the argument that the body economic would be better off if capital gains were not taxed. Congress has never shown any disposition, however, to relieve capital gains entirely from taxation. From one point of view, it may be said that profits on the stock market (when made) have as great purchasing power as any other kind of income. On the other hand, in a time of generally increasing prices, capital gains may be largely or wholly illusory, as a man finds out when he sells his house in one city in connection with a business move, and then tries to buy a corresponding house in the city to which he goes. Reference is often made to the fact that capital gains are not taxed under the English income tax.

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1 For general discussion, see Surrey, "Definitional Problems in Capital Gains Taxation," 69 Harv.L.Rev. 985 (1956); Hulse, "The Capital Gains Tax and the Stock Market," 34 Taxes 519 (1956); Tudor, "The Equitable Justification for the Capital Gains Tax," 34 Taxes 643 (1956); Tudor, "Exemption of Capital Gains from the Capital Gains Tax," 35 Taxes 101 (1957); Blum, "A Handy Summary of the Capital Gains Arguments," 35 Taxes 247 (1957); Judicial Limitations upon Acquisitions of Capital Gains Treatment on Sale of Contract Rights," 32 Temple L.Q. 202 (1959); Modesitt, "Capital Gains on Oil and Gas Transactions," 27 Rocky Mountain L.Rev. 39 (1954); Oram, "Capital Gains of Dealers in Real Property," 33 Taxes 147 (1955); Magill and Kosmian, "Income, Deductions, Gains and Losses," 68 Harv.L.Rev. 201 (1954).

But profits "in trade" are taxed, and the line includes a good many items that we would call capital gain.[2]

On the general question, see Seltzer, "Evolution of the Special Legal Status of Capital Gains under the Income Tax," 3 Nat.Tax J. 18 (1950); Gemmill, "The Effect of the Capital Gains Tax on Asset Prices," 9 Nat.Tax J. 289 (1956); Somers, "An Economic Analysis of the Capital Gains Tax," 1 Nat.Tax J. 226 (1948); Lutz, "Should Capital Gains Be Taxed As Income?" 22 Bull.Nat. Tax Assn. 130 (1937); Simons, Personal Income Taxation, c. VII (1938); Coyle, Why Pay Taxes 81–89 (1937); Powell, "Income From Sales of Investments," 6 Bull.Nat.Tax Assn. 137 (1921); Powell, "Profit on the Sale of Capital as Income Under the Sixteenth Amendment," 21 Col.L.Rev. 163 (1921).[3]

Comprehensive treatments of the general problem of the tax treatment of capital gains and losses may be found in:

Federal Income Tax Treatment of Capital Gains and Losses—A Treasury Tax Study (1951).

Seltzer, The Nature and Tax Treatment of Capital Gains and Losses (1951), reviewed by Norris Darrell in 65 Harv.L.Rev. 709 (1952). Consider the following passage from the latter review: "The reasons why differing concepts of capital gains and losses grew up in Europe and in the United States are not always understood. In England and elsewhere in post-feudal Europe, land was the principal source of wealth. It was customary for landed estates to be entailed, which meant that the estates went to specified heirs who were entitled to the income for life but could not sell; and sales of other kinds of capital assets were relatively infrequent. A man's wealth was commonly measured by his income and not by the value of the property from which it was derived. Capital was regarded more or less as a *res* or physical thing, and the rise or fall in its value, whether realized or not, was regarded as irrelevant to the determination of income. When income taxation was introduced during the eighteenth century, it was therefore natural that taxable income should be limited to recurring income from specific sources.

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2 The English practice is extensively reviewed in Magill, Taxable Income 82–103 (Rev. ed. 1945). See also Peden, "Taxation of Capital Gains in the United States, the United Kingdom, and Canada," 28 Fordham L.Rev. 435 (1959); Perry, "Capital Gains—The British Point of View," 1 Canadian Tax J. 548 (1953).

For an argument that capital gains derived in transactions entered into for profit should be made taxable in Canada, see McDonald, "Capital Gains and Losses in Canada," 29 Can.Bar Rev. 907 (1951).

3 Further references include Jessup, "Capital Gains and Losses Since 1922," 17 Taxes 333 (1939); Fagan, "The Economics of Capital Gains Taxation," Proc.Nat.Tax Ass'n. 113 (1939); Kent, "Taxation of Capital Gains and Losses," 16 Tax Mag. 389 (1938); Atlas, "Capital Gains Taxation," 13 Accounting Rev. 346 (1938); Tremaine, "The Capital Gains Tax," 15 Tax Mag. 517 (1937).

"The situation as it later developed in the United States was quite different. Land, being plentiful and cheap, carried less social prestige, and the result was less continuity of family ownership. With increasing industrialization, investments in business enterprise became a much more important source of wealth. Rapid economic changes resulted in large increases in values that were frequently converted into realized gains which, indeed, were often deliberately sought. Even farmers bought farms with the two fold purpose of deriving income from farming and realizing on increased land values. In this atmosphere, the value of a man's capital, rather than his income therefrom, was generally regarded as the measure of his wealth. For these and other reasons, which the book so well brings out, the concept of capital gains as capital and not income never obtained as strong a hold in the United States as it did abroad."

B. HOW SHOULD CAPITAL GAINS BE TAXED?

It is a wholly different question to ask how capital gains should be taxed. In fact, Congress has never been able to answer this satisfactorily. Taxing them at the regular rate seems unfair, for it throws into one year and a possible high bracket a profit which may have been many years in accumulating. Moreover, it is argued, and with some force, that to tax capital gains too high serves to induce people not to sell, thus creating an artificial scarcity which forces prices higher and higher until they collapse. Beginning with 1921, Congress provided that where assets had been held for more than two years, they should not be taxed at a higher rate than 12½ per cent. In 1924, it was provided that capital losses would not be deductible at more than 12½ per cent. In 1932, Congress provided that capital losses could not be deducted at all, except to offset capital gains. From that time on, the capital gain and loss provisions have been subject to a good deal of rather bewildering tinkering.[4]

The Twentieth Century Fund, in Facing the Tax Problem 490 (1937) recommended that capital gains should be taxed on an inventory basis, that is, that each taxpayer should be required to report the value of his property at the end of each year, and treat as gain (or loss) the increase (or decrease) in value since the end of the preceding year. Would this be administratively feasible? *Cf.* Maguire, Book Review in 38 Col.L.Rev. 710, 714, (1938): "Such procedure might do a great deal to end unemployment, but hardly qualifies as a practical method of adminis-

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[4] The provisions in all of the acts down to 1940 are summarized in Blakey, The Federal Income Tax, 586–588 (1940). See also Wells, "Legislative History of Treatment of Capital Gains under the Federal Income Tax," 2 Nat.Tax J. 12 (1949).

tering an income tax." Would it be constitutional?[5] *Cf.* sec. 1.471–5 of the Income Tax Regulations, which authorizes dealers in securities to use inventories. This is optional, but the general inventory provisions in sec. 1.471–1 of the Regulations are compulsory. Does this not result in substance in the recognition for tax purposes of unrealized gains or losses?[6]

For many years, the basic provisions with respect to the taxation of capital gains and losses were found in sec. 117 of the 1939 Code. The corresponding provisions now appear in secs. 1201–1241 of the 1954 Code.

These sections should be carefully read, and their provisions digested. Since they must be read in any event, no effort will be made to summarize them here. This is probably the most satisfactory scheme that Congress has yet devised. But it does not satisfy all by any means, and is surely not completely satisfactory to anyone. Some think it goes too far in extending privileges to recipients of capital gains; some think it does not go far enough. For an excellent discussion of the problem, see Lowndes, "The Taxation of Capital Gains and Losses under the Federal Income Tax," 26 Tex.L.Rev. 440 (1948).

The effect of the present scheme for handling capital gains and losses may be summarized as follows:

First the net of all short term transactions is taken. There may be either a short term gain (STG), or a short term loss (STL).

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5 In Lynch v. Turrish, 247 U.S. 221, 230 (1918), the Supreme Court quoted with approval the following statement from Gray v. Darlington, 15 Wall. 63, 66 (1872): "Mere advance in value in no sense constitutes the gains, profits or income specified by the statute." In Eisner v. Macomber, 252 U.S. 189, 207 (1920), the Court said that income was "*not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment." *Cf.* Powell, "Constitutional Aspects of Federal Income Taxation," in The Federal Income Tax (1921) 51, 82: "'Realized gain' is a pretty sensible definition of income for a practical man, however it may seem to an expert conceptualist." See also Magill, Taxable Income 106–113 (2d ed. 1945).

6 See also Corbin, "New Proposals for Capital Gains Taxation," 34 Taxes 663 (1956); Clark, "An Alternative to Capital Gains Taxation: A 'Roll-Over' Account for Investment Assets," 4 Howard L.Rev. 157 (1958); Krager and Barton, "The Tax Dilemma of the Entertainer," 31 So.Calif.L.Rev. 390 (1958); Miller, "Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code," 64 Yale L.J. 1 (1954); Dakin, "The Capital Gains Treasure Chest: Rational Extension or Expedient Distortion?" 14 Louisiana L.Rev. 505 (1954); Bangs, "The Dilemma of the Cut Rate Tax," 31 Taxes 31 (1953); Bravman, "Integration of Taxes on Capital Gains and Income," 37 Va.L.Rev. 527 (1951).

Then the same is done with the long term transactions. These may result in a long term gain (LTG), or a long term loss (LTL).

1. If there is an *over-all loss,* no matter whether short term or long term, $1,000 is deductible from ordinary income, and the balance may be used as a carry-over for five years, as a short term capital loss. Such a loss may be the result of an STL alone, or an LTL alone, or an STL and an LTL together, or an STL exceeding an LTG, or an LTL exceeding an STG.

2. If there is *a net gain which is short term,* the net gain is taxable in full at ordinary rates. This may be the result of an STG alone, or of an STG exceeding an LTL.

3. If there is *a net gain which is long term,* half of the net gain is deductible, and the full gain is, in any event subject to a maximum tax rate of 25%. This may arise where there is an LTG alone, or an LTG exceeding an STL.

4. If there is *both an STG and an LTG,* the STG is subject to tax at full rates, and the LTG is taxable as in the previous paragraph.

Notes

(A) Is it desirable to have the line between short term gains and long term gains set at six months? If the period cannot be made longer, at least two years, would it not be better to eliminate the distinction entirely and give all capital gains and losses the same treatment that is now applied to long term gains and losses?

(B) The maximum rate of tax on long term capital gains is fixed at 25%. See sec. 1201 of the 1954 Code, taken in connection with sec. 1202. (For (approximately) the years 1952 and 1953, this rate, under the old Code, was 26%.)

(C) The deduction in sec. 1202 seems a little odd when first encountered. This method of reaching the ultimate result was introduced in 1951. It has two basic purposes: (1) to give some benefit of capital gains treatment to taxpayers whose incomes do not reach above the 25% bracket; and (2) to eliminate the situation which existed under the previous law whereby one dollar of short term capital loss could be used to offset two dollars of long term capital gain. Under the new provision, a short term capital loss will only offset a corresponding dollar amount of long term capital gain.

It all makes sense when you understand it—but it takes a certain amount of understanding.

Capital loss carryover. The capital loss carryover is provided in sec. 1212 of the 1954 Code.

Under sec. 1211, corporations can deduct capital losses only against capital gains; and other taxpayers (individuals, trusts) can deduct capital losses only to the extent of gains plus $1,000 (if the net income is that much). But the unused capital loss may be carried forward as a short term capital loss in each of the succeeding five years, until it is used up. If it is not used up within the five years, it is gone.

Where a decedent had an unused capital loss, it may not be utilized by his estate. Rev.Rul. 54–207, 1954–1 Cum.Bull. 147.

In the case of losses sustained by trusts, see sec. 642(h). Prior to the introduction of this provision in the 1954 Code, it was held that a remainderman, who took over the trust property, could not use the loss as a carryover on his own return for a later year. *Charles F. Neave,* 17 T.C. 1237 (1952).

C. PRELIMINARY CONSIDERATIONS

ARROWSMITH v. COMMISSIONER

Supreme Court of the United States, 1952. 344 U.S. 6.

MR. JUSTICE BLACK delivered the opinion of the Court.

This is an income tax controversy growing out of the following facts as shown by findings of the Tax Court. In 1937 two taxpayers, petitioners here, decided to liquidate and divide the proceeds of a corporation in which they had equal stock ownership.* Partial distributions made in 1937, 1938, and 1939 were followed by a final one in 1940. Petitioners reported the profits obtained from this transaction, classifying them as capital gains. They thereby paid less income tax than would have been required had the income been attributed to ordinary business transactions for profit. About the propriety of these 1937–1940 returns, there is no dispute. But in 1944 a judgment was rendered against the old corporation and against Frederick R. Bauer, individually. The two taxpayers were required to and did pay the judgment for the corporation, of whose assets they were transferees. See *Phillips-Jones Corp. v. Parmley,* 302 U.S. 233, 235–236. Cf. I.R.C. § 311 (a). Classifying the loss as an ordinary business one, each took a tax deduction for 100% of the amount paid. Treatment of the loss as a capital one would have allowed deduction of a much smaller amount. See I.R.C., § 117(b), (d) (2) and (e). The Commissioner viewed the 1944 payment as part of the original liqui-

* At dissolution the corporate stock was owned by Frederick P. Bauer and the executor of Davenport Pogue's estate. The parties here now are Pogue's widow, Bauer's widow and the executor of Bauer's estate.

dation transaction requiring classification as a capital loss, just as the taxpayers had treated the original dividends as capital gains. Disagreeing with the Commissioner the Tax Court classified the 1944 payment as an ordinary business loss. 15 T.C. 876. Disagreeing with the Tax Court the Court of Appeals reversed, treating the loss as "capital." 193 F.2d 734. This latter holding conflicts with the Third Circuit's holding in *Commissioner v. Switlik*, 184 F.2d 299. Because of this conflict, we granted certiorari.

I.R.C. § 23 treats losses from sales or exchanges of capital assets as "capital losses" and I.R.C. § 115 requires that liquidation distributions be treated as exchanges. The losses here fall squarely within the definition of "capital losses" contained in these sections. Taxpayers were required to pay the judgment because of liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings. It is not even denied that had this judgment been paid after liquidation, but during the year 1940, the losses would have been properly treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains taxpayers received during that year.

It is contended, however, that this payment which would have been a capital transaction in 1940 was transformed into an ordinary business transaction in 1944 because of the well-established principle that each taxable year is a separate unit for tax accounting purposes. *United States v. Lewis,* 340 U.S. 590; *North American Oil Co. v. Burnet,* 286 U.S. 417. But this principle is not breached by considering all the 1937–1944 liquidation transaction events in order properly to classify the nature of the 1944 loss for tax purposes. Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.

The petitioner Bauer's executor presents an argument for reversal which applies to Bauer alone. He was liable not only by reason of being a transferee of the corporate assets. He was also held liable jointly with the original corporation, on findings that he had secretly profited because of a breach of his fiduciary relationship to the judgment creditor. *Trounstine v. Bauer, Pogue & Co.,* 44 F.Supp. 767, 773; 144 F.2d 379, 382. The judgment was against both Bauer and the corporation. For this reason it is contended that the nature of Bauer's tax deduction should be considered on the basis of his liability as an individual who sustained a loss in an ordinary business transaction for profit. We agree with the Court of Appeals that this contention should not be sustained. While there was a liability against him in both capacities,

the individual judgment against him was for the whole amount. His payment of only half the judgment indicates that both he and the other transferee were paying in their capacities as such. We see no reason for giving Bauer a preferred tax position.

Affirmed.

MR. JUSTICE DOUGLAS, dissenting.

I agree with MR. JUSTICE JACKSON that these losses should be treated as ordinary, not capital, losses. There were no capital transactions in the year in which the losses were suffered. Those transactions occurred and were accounted for in earlier years in accord with the established principle that each year is a separate unit for tax accounting purposes. See *United States v. Lewis,* 340 U.S. 590. I have not felt, as my dissent in the *Lewis* case indicates, that the law made that an inexorable principle. But if it is the law, we should require observance of it—not merely by taxpayers but by the government as well. We should force each year to stand on its own footing, whoever may gain or lose from it in a particular case. We impeach that principle when we treat this year's losses as if they diminished last year's gains.

MR. JUSTICE JACKSON, whom MR. JUSTICE FRANKFURTER joins, dissenting.

This problem arises only because the judgment was rendered in a taxable year subsequent to the liquidation.

Had the liability of the transferor-corporation been reduced to judgment during the taxable year in which liquidation occurred, or prior thereto, this problem, under the tax laws, would not arise. The amount of the judgment rendered against the corporation would have decreased the amount it had available for distribution, which would have reduced the liquidating dividends proportionately and diminished the capital gains taxes assessed against the stockholders. Probably it would also have decreased the corporation's own taxable income.

Congress might have allowed, under such circumstances, tax returns of the prior year to be reopened or readjusted so as to give the same tax results as would have obtained had the liability become known prior to liquidation. Such a solution is foreclosed to us and the alternatives left are to regard the judgment liability fastened by operation of law on the transferee as an ordinary loss for the year of adjudication or to regard it as a capital loss for such year.

This Court simplifies the choice to one of reading the English language, and declares that the losses here come "squarely within" the definition of capital losses contained within two sections of the Internal Revenue Code. What seems so clear to this Court was not seen at all by the Tax Court, in this case or in earlier con-

sideration of the same issue; nor was it grasped by the Court of Appeals for the Third Circuit. *Commissioner v. Switlik,* 184 F.2d 299 (1950). . . .

Solicitude for the revenues is a plausible but treacherous basis upon which to decide a particular tax case. A victory may have implications which in future cases will cost the Treasury more than a defeat. This might be such a case, for anything I know. Suppose that subsequent to liquidation it is found that a corporation has undisclosed claims instead of liabilities and that under applicable state law they may be prosecuted for the benefit of the stockholders. The logic of the Court's decision here, if adhered to, would result in a lesser return to the Government than if the recoveries were considered ordinary income. Would it be so clear that this is a capital loss if the shoe were on the other foot?

Where the statute is so indecisive and the importance of a particular holding lies in its rational and harmonious relation to the general scheme of the tax law, I think great deference is due the twice-expressed judgment of the Tax Court. In spite of the gelding of *Dobson v. Commissioner,* 320 U.S. 489, by the recent revision of the Judicial Code, Act of June 25, 1948, Pub.Law No. 773, § 36, 62 Stat. 991–992, I still think the Tax Court is a more competent and steady influence toward a systematic body of tax law than our sporadic omnipotence in a field beset with invisible boomerangs. I should reverse, in reliance upon the Tax Court's judgment more, perhaps, than my own.

Notes

(A) See "The Consideration of Transactions in Prior Taxable Years as a Means of Classifying Gains and Losses," 31 Texas L. Rev. 884 (1953); Schwarts, "Transferee Liability Following Corporate Liquidation: The Income Tax Consequences to the Former Stockholders," 7 Tax L.Rev. 504 (1952).

(B) A taxpayer buys stock in 1929. In 1933, he sells it at a loss and deducts the loss as a capital loss. In 1936 he starts a suit against his vendor, and in 1937 receives a sum of money in settlement of his claim. Is the the sum so received taxable as a capital gain or as ordinary income? See *Dobson v. Commissioner,* 321 U.S. 231 (1944), an opinion on rehearing following the opinion in *Dobson v. Commissioner,* 320 U.S. 489 (1943).

COMMISSIONER v. BAGLEY & SEWALL CO.

United States Court of Appeals, Second Circuit, 1955. 221 F.2d 944.

Before FRANK and MEDINA, CIRCUIT JUDGES, and BRENNAN, DISTRICT JUDGE.

BRENNAN, DISTRICT JUDGE. Whether or not the loss incurred in the posting of U. S. Government bonds as security for the

performance of a contract is a capital loss or a business expense is the question posed on this appeal.

A background of essential facts were submitted by stipulation to the Tax Court. The Bagley & Sewall Co. (hereinafter referred to as the taxpayer), is a New York corporation engaged in the manufacture and sale of paper making machinery. In 1946 the taxpayer entered into a contract with a corporation acting in behalf of the Government of Finland for the manufacture and delivery of two paper making machines at a cost of approximately $1,800,000. Payments were to be made periodically during the progress of manufacture. The Government of Finland required that U. S. 2½% Government bonds be deposited with a New York financial institution as security for the performance of the contract and in accordance with an agreement which provided for the return of the bonds to Bagley & Sewall upon receipt of the last payment due under the contract. The above provisions were incorporated in and made a part of the contract. The taxpayer did not have or own the required bonds and in order to carry out the provisions of the contract, U. S. Government bonds in a total face value of $800,000 were purchased by the taxpayer with moneys borrowed for that purpose and same were deposited as required by the contract, the total cost of same being $820,062.50. The interest earned upon the bonds during the period that they were held in escrow was reported as income received by the taxpayer. In accordance with the terms of the contract, the bonds were released in two lots, one of $400,000 face value on Sept. 7, 1948 and one of $400,000 face value on Sept. 22, 1948. The bonds were sold by the taxpayer in each instance a few days after their release resulting in a loss of approximately $15,000 which the taxpayer claimed, in its tax return for 1948, as an ordinary and necessary business expense. During the period that the bonds were held in escrow and until they were sold, they were carried in the general ledger of the taxpayer in an account entitled "U. S. Gov't Bonds" and on its balance sheet of Dec. 31, 1946 and Dec. 31, 1947, the bonds were shown under the caption "U. S. Gov't Bonds".

Upon re-audit, the Commissioner of Internal Revenue determined a deficiency in the taxpayer's 1948 return on the ground that the above loss was a capital loss under Section 117(a)(1) of the Internal Revenue Code of 1939. The matter came on before the Tax Court and after making minor adjustments, which are not here in dispute, the Tax Court found in effect in accordance with the claim of the taxpayer that the sale of the bonds was of assets held for sale in the ordinary course of petitioner's business and the loss was deductible as an ordinary and reasonable business expense.

The findings made are substantially as outlined above with the following additions * * * that the taxpayer was not in the business of buying and selling securities, that its available cash reserve was necessary for working capital, that it is clear that no investment in U. S. bonds was intended by the petitioner, they were acquired solely to carry out a condition imposed by the contract. It was concluded that the purchase and sale of these bonds was merely an incident in the carrying on by the petitioner of its regular business of manufacturing and selling paper making machines. The Tax Court relied upon the decisions in *Western Wine & Liquor Co.*, 18 T.C. 1090 and *Charles A. Clark,* 19 T.C. 48 and distinguished the case of *Exposition Souvenir Corp. v. Commissioner,* 2 Cir., 163 F.2d 283. This appeal followed.

Concisely stated, the contention by the Commissioner is that the bonds constituted capital assets, as the term is defined in Section 117(a)(1) of the Internal Revenue Code and that the loss sustained upon their sale is to be treated as a capital loss to the extent of offsetting capital gains, none of which are reported by the taxpayer and therefore the whole item is subject to elimination.

The taxpayer's contention is to the effect that the whole transaction is merely an incident required and made necessary in the performance of a contract undertaken in the regular course of the taxpayer's business and is deductible from gross income in its entirety by reason of the provision of Section 23(a)(1)(A) of the Internal Revenue Code of 1939.

The difficulty with the Commissioner's contention is that in effect he urges that the bond transaction should be considered independently of the contract of which it is a definite part. This circuit in *Helvering v. New Haven & S. L. R. Co.*, 121 F.2d 985, at page 988 has held that a contract may not be thus atomized.

In *Exposition Souvenir Corp. v. Commissioner,* 2 Cir., 163 F.2d 283, the taxpayer was required to make an investment, related to, but not a part of the concession contract. This is not the situation here. The contract represents a complete business transaction, security of performance alone, not investment was required. The cost of procuring that security cannot be distinguished from ordinary premium expense of a surety company bond which is a usual item of contractor's costs. The Exposition case may be further distinguished by the fact that the debentures were treated as investments in the taxpayer's books and tax returns and in that case the Tax Court made a finding that the debentures were not held for sale in the ordinary course of business. There is no such treatment of this transaction in this taxpayer's tax return and no such finding. It is implicit that the Tax Court found that the bonds here were held for sale

to purchasers as soon as released from escrow and available for sale. In the Exposition case, an investment was intended and the taxpayer relied upon the motive for the investment for relief. Here there is a clear finding that no investment was intended. The Taxpayer's lack of surplus capital, the interest return of the bonds, the interest obligation of the loan and the almost immediate sale of the bonds when available make such a finding imperative. The finding here in this respect is similar to that made in *Gilbert v. Commissioner,* 1 Cir., 56 F.2d 361.

In brief, it is urged that the all inclusive language of Section 117 requires that, since the bonds are "property", they must be treated as capital assets unless exempted by the specific language of the Section. The argument carries with it the necessary conclusion that the circumstances of the transaction, its factual background, the necessities of the business involved and the intentions of taxpayer are of no importance except in determining whether the bonds are exempted under the Section. We are not persuaded that Section 23 is so completely subordinate to Section 117 and we find no authority which goes so far.

"Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances". *Commissioner of Internal Revenue v. Heininger,* 320 U.S. 467, at page 475. The purchase of stock in order to terminate an agency contract was held to be business expense. *Helvering v. Community Bond & Mortgage Corporation,* 2 Cir., 74 F.2d 727. The purchase of stock in a non-profit corporation to aid business was held to be a business expense. *Commissioner of Internal Revenue v. The Hub,* 4 Cir., 68 F.2d 349. The purchase of stock of a liquor corporation in order to purchase liquor therefrom was held to be business expense. *Hogg v. Allen,* D.C., 105 F.Supp. 12, affirmed, *Edwards v. Hogg,* 5 Cir., 214 F.2d 640, 644. We find similar holdings by the Tax Court especially the two cases relied upon by that Court and referred to above. The above authorities are cited here not to show that we necessarily agree with the conclusions therein but as an indication that business expense, Section 23, has been many times determined by business necessity without a specific consideration of Section 117.

An appreciation of the particular situation, *Welch v. Helvering,* 290 U.S. 111, at page 116, to which is applied the pertinent sections of the law according to common understanding and experience, *Helvering v. Horst,* 311 U.S. 112, is the measure of the law's requirement.

We find no comparable authority wherein a contract is dissected and its separate parts are subjected to application of particular sections of the Revenue Law. The Tax Court was right

in refusing to wrench this transaction from its setting and its finding and conclusion is amply supported by evidence. To decide otherwise is to apply the law so as to escape reality.

The decision is affirmed.

FRANK, CIRCUIT JUDGE (dissenting). Congress, in Section 23, prescribed the items which may be deducted in computing net income. In Section 23(g)(1), it provided that "losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117." Then, in Section 117, sub-paragraph (a)(1), Congress explicitly defined "capital assets" to mean "property held by the taxpayer (whether or not connected with his trade or business)". Had Congress stopped there, perhaps it would be proper to do, as my colleagues do, i. e., to find in Section 23(a)(1)(A) and (f) exceptions to the definition contained in Section 117(a)(1). But Congress, in Section 117(a)(1), went on very explicitly to enumerate the exceptions to the definition, by saying that the term "capital assets" does "not include"

"stock in trade of the taxpayer";

"other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year";

"property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business";

"property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23(*l*)";

"an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue";

"real property used in the trade or business of the taxpayer."

The property in the instant case does not fit into any of those exceptions. I think that a court, facing such explicit statutory exceptions, has no power to invent another by recourse to other general statutory provisions—Section 23(a)(1)(A) and (f)—which do not refer to Section 117 and to which Section 117 does not refer. . . .

My conclusion here derives from no ardent desire to add to the government's revenues by invariably interpreting statutes adverse to taxpayers; see, e. g., my dissenting opinion in *Babcock & Wilcox Co. v. Pedrick,* 2 Cir., 212 F.2d 645. But I think that courts should not allow what they deem fairness to taxpayers to over-ride one of the most sensible canons of statutory construction, i. e., that, where a statute sets forth specific excep-

tions, further exceptions, by way of mere implication, are not permissible. Moreover, to hold for the taxpayer here may well mean unfairness to other taxpayers who, having acquired securities in situations just like this, but having made a gain on the sale of the securities, seek to claim that their taxable profits are capital gains, not ordinary income.

Notes

(A) There are comments on this case in 69 Harv.L.Rev. 761 (1956); 41 Va.L.Rev. 820 (1955); 55 Col.L.Rev. 1228 (1955); 104 U. of Pa.L.Rev. 439 (1955); 41 A.B.A.J. 966 (1955).

The result of the case is now accepted by the Treasury. Rev. Rul. 58–40, 1958–1 Cum.Bull. 275.

(B) Substantially the same result was reached by the Tax Court in *Tulane Hardwood Lumber Co.*, 24 T.C. 1146 (1955), where the taxpayer purchased debentures in order to assure a source of supply of hardwood. The debentures became worthless. This was held to produce an ordinary loss. To the same effect is *Electrical Fittings Corp.*, 33 T.C. —— (1960). See also *Wool Distributing Corp.*, 34 T.C. —— (1960).

(C) In *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), it appeared that the taxpayer purchased corn futures. These are contracts traded in on national grain exchanges. When a person buys a corn future, he obtains the right to the delivery of the specified amount of corn in the month specified in the future contract. The taxpayer purchased the corn futures in order to assure itself of a source of supply, and to protect itself against price increases. Sometimes it took delivery under the futures contracts. In other cases, it sold the futures contracts, and bought "spot" corn, that is, corn for immediate delivery.

In 1940, it had a profit on the sale of its futures contracts. In 1942, it suffered a loss on the sale of these contracts. The court held that these were ordinary gains and losses. It said that it sustained the lower courts which had found that "petitioners' futures transactions" were "an integral part of its business." The taxpayer's contention that the futures were "property" was rejected. The reason given was that "the capital asset provision of Section 117 must not be so broadly applied as to defeat rather than further the purpose of Congress."

For discussion, see "Judicial Treatment of 'Capital' Assets Acquired for Business: The New Criterion," 65 Yale L.J. 401 (1956); Freeman, "Is There a New Concept of a Business Asset?" 36 Taxes 110 (1958); Kulick, "Taxation of Commodity Futures Used as Hedges," 13 Tax L.Rev. 87 (1957).

MANSFIELD JOURNAL CO. v. COMMISSIONER

United States Court of Appeals, Sixth Circuit, 1960.
274 F.2d 284.

MARTIN, CIRCUIT JUDGE. This is a petition for review of a decision of the Tax Court of the United States finding deficiencies in the petitioner's income tax for the taxable years 1951 and

1952 in amounts of $41,041.72 and $13,930.69, respectively. The question presented is whether considerations paid for the assignments of the right to purchase newsprint under a long-term contract are taxable as capital gains, or as ordinary income.

Mansfield Journal Company, petitioner, is a daily newspaper publishing corporation in Mansfield, Ohio, owned at the crucial time by S. A. Horvitz and I. Horvitz, who also owned the Lorain Journal Company, a separate corporation publishing a daily newspaper in Lorain, Ohio. Petitioner's income was reported on an accrual basis, which conformed to its method of bookkeeping.

In the newspaper publishing business, it is necessary that the publisher be assured of a continuous supply of newsprint. So, in order to obtain a ten-year contract for a supply of one thousand tons of newsprint annually at reasonable cost, petitioner entered into an agreement with Coosa River Newsprint Company. Simultaneously, the publishing company entered into a separate contract with Coosa River to purchase two thousand shares of that company's stock at fifty dollars per share, or a total consideration of $100,000. The manner of fixing the price of each shipment of newsprint was set out in the supply contract; and, although the Lorain Journal Company could take deliveries thereunder, petitioner's rights under the contract could not be assigned to others without the good-faith consent of the Coosa River Company.

During 1950 and 1951, the petitioner assigned its rights to receive portions of the newsprint tonnage under the supply contract to four other newspaper publishing companies: Kansas City Star Company; Brush-Moore Newspapers, Inc.; Beacon Publishing Company; and Lorain County Printing and Publishing Company. The last-named company is not connected with the Lorain Journal Company. These assignments were made with the consent of Coosa River Newsprint Company.

At no time did the Mansfield Journal Company take delivery or possession of the newsprint assigned. In each case, the assignee paid to Coosa River directly the amount which petitioner would have paid for the same paper under the supply contract; and, with the exception of the Kansas City Star Company, each assignee paid to the petitioner an additional sum as consideration for the assignment.

These payments were reported as long-term capital gains from the sale of "contract rights" in petitioners' 1951 and 1952 income tax returns. The respective amounts reported were $73,617.43 and $22,237.83, representing the full amounts received by petitioner as consideration for the assignments of the "contract rights" in 1950 and 1951. The basis of the rights sold was stated on the returns to be zero. The Commissioner and the Tax Court

determined that the sums received by petitioner from its various assignees in 1951 and 1952 were ordinary income under section 22(a) and not capital gains under section 117(a), 26 U.S.C.A. §§ 22(a), 117(a), as reported.

The ten-year contract between Coosa River Newsprint Company and the petitioner, whereby the former agreed to supply newsprint to the latter, is in the nature of a commodity future: it was a contract to purchase at future dates a fixed amount of newsprint at a determinable price, in order to protect petitioner against erratic prices and a lack of availability of newsprint.

This supply contract provided the petitioner with business-risk protection, in that it gave assurance that the publishing company would not be forced to buy newsprint for its business at uncertain spot-market prices, or that it would not be entirely deprived of a supply. The contract was unalterably tied in with and related to petitioner's publishing business. The contract for newsprint supply cannot reasonably be considered an "investment" by the Mansfield Journal. The petitioner's contention that the contract with the Coosa River Company was separate from its publishing business is not supported by the record. The motive of Mansfield Journal Company in obtaining the contract appears to have been, not that of a capital investor, but that of a far-sighted manufacturer. See *Grote v. Commissioner,* 41 B.T.A. 247.

Corn Products Co. v. Commissioner, 350 U.S. 46, 47, 50–53 is in point. It was there held that a manufacturer of corn products which bought and sold corn futures as an integral part of its manufacturing business, but not as "true hedges", was not engaging in capital-asset transactions under section 117(a) of the Internal Revenue Code of 1939; and that gains and losses from such transactions gave rise to ordinary income and ordinary deductions. The futures purchases not only protected the manufacturer from an increase in price, but also insured a source of supply of corn. It was held that, while the Corn Products Company had "purchased partial insurance against its principal risk", gains from such program "closely geared to a company's manufacturing enterprise or more important to its successful operation" should come under ordinary income, by reason of the intention of Congress that "profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss."

The preferential tax treatment given capital gains carries with it the implication that the definition of a capital asset should be construed narrowly and its exclusions interpreted broadly. *Corn Products Co. v. Commissioner, supra; Burnet v. Harmel,* 287 U.S. 103; *Hort v. Commissioner,* 313 U.S. 28, 31; *Kieselbach v. Commissioner,* 317 U.S. 399, 403.

We agree with the decision of the Tax Court that the consideration received by the petitioner, Mansfield Journal Company, for each of the assignments herein is taxable as ordinary income under section 22(a) and not as long-term capital gain under section 117(a).

The decision is, accordingly, affirmed.

Note

Would the result have been any different if the taxpayer had sold the entire contract, covering several years' production, rather than several pieces of it, of short duration? Suppose the taxpayer had gone bankrupt, and its trustee in bankruptcy had sold the contract in its entirety. Would the proceeds have been capital gain or ordinary income? Cf. *Bankline Oil Co. v. Commissioner*, 275 F.2d 781 (C.A.9th, 1960), where the taxpayer had a contract for rendering services in processing gas. It sold the entire contract. The court held that, under the circumstances, the proceeds received for the contract were taxable as ordinary income.

D. WHAT IS A CAPITAL ASSET?

Sec. 1221 of the 1954 Code, and sec. 1.1221–1 of the Income Tax Regulations

WILLIAMS v. McGOWAN

Circuit Court of Appeals, Second Circuit, 1945. 152 F.2d 570.

L. HAND, CIRCUIT JUDGE. This is an appeal from a judgment dismissing the complaint in an action by a taxpayer to recover income taxes paid for the year 1940. . . . Williams, the taxpayer, and one, Reynolds, had for many years been engaged in the hardware business in the City of Corning, New York. On the 20th of January, 1926, they formed a partnership, of which Williams was entitled to two-thirds of the profits, and Reynolds, one-third. They agreed that on February 1, 1925, the capital invested in the business had been $118,082.05, of which Reynolds had a credit of $29,029.03, and Williams, the balance—$89,053.02. At the end of every business year, on February 1st, Reynolds was to pay to Williams interest upon the amount of the difference between his share of the capital and one-third of the total as shown by the inventory; and upon withdrawal of one party the other was to have the privilege of buying the other's interest as it appeared on the books. The business was carried on through the firm's fiscal year, ending January 31, 1940, in accordance with this agreement, and thereafter until Reynolds' death on July 18th of that year. Williams settled with Reynolds' executrix on September 6th in an agreement by which

he promised to pay her $12,187.90, and to assume all liabilities of the business; and he did pay her $2,187.98 in cash at once, and $10,000 on the 10th of the following October. On September 17th of the same year, Williams sold the business as a whole to the Corning Building Company for $63,926.28—its agreed value as of February 1, 1940—"plus an amount to be computed by multiplying the gross sales of the business from the first day of February, 1940 to the 28th day of September, 1940," by an agreed fraction. This value was made up of cash of about $8100, receivables of about $7000, fixtures of about $800, and a merchandise inventory of about $49,000, less some $1000 for bills payable. To this was added about $6,000 credited to Williams for profits under the language just quoted, making a total of nearly $70,000. Upon this sale Williams suffered a loss upon his original two-thirds of the business, but he made a small gain upon the one-third which he had bought from Reynolds' executrix and in his income tax return he entered both as items of "ordinary income," and not as transactions in "capital assets." This the Commissioner disallowed and recomputed the tax accordingly; Williams paid the deficiency and sued to recover it in this action. The only question is whether the business was "capital assets" under § 117(a)(1) of the Internal Revenue Code.

It has been held that a partner's interest in a going firm is for tax purposes to be regarded as a "capital asset." *Stilgenbaur v. United States,* 9 Cir., 115 F.2d 283; *Commissioner v. Shapiro,* 6 Cir., 125 F.2d 532, 144 A.L.R. 349. We too accepted the doctrine in *McClellan v. Commissioner,* 2 Cir., 117 F.2d 988, although we had held the opposite in *Helvering v. Smith,* 2 Cir., 90 F.2d 590, 591, where the partnership articles had provided that a retiring partner should receive as his share only his percentage of the sums "actually collected" and "of all earnings * * * for services performed." Such a payment, we thought, was income; and we expressly repudiated the notion that the Uniform Partnership Act had, generally speaking, changed the firm into a juristic entity. See also *Doyle v. Commissioner,* 4 Cir., 102 F.2d 86. If a partner's interest in a going firm is "capital assets" perhaps a dead partner's interest is the same. New York Partnership Law §§ 61, 62(4), Consol.Laws N.Y. c. 39. We need not say. When Williams bought out Reynolds' interest, he became the sole owner of the business, the firm had ended upon any theory, and the situation for tax purposes was no other than if Reynolds had never been a partner at all, except that to the extent of one-third of the "amount realized" on Williams' sale to the Corning Company, his "basis" was different. The judge thought that, because upon that sale both parties fixed the price at the liquidation value of the business while Reynolds was alive, "plus" its estimated earnings thereafter, it was as though Williams had

sold his interest in the firm during its existence. But the method by which the parties agreed upon the price was irrelevant to the computation of Williams' income. The Treasury, if that served its interest, need not heed any fiction which the parties found it convenient to adopt; nor need Williams do the same in his dealings with the Treasury. We have to decide only whether upon the sale of a going business it is to be comminuted into its fragments, and these are to be separately matched against the definition in § 117(a)(1), or whether the whole business is to be treated as if it were a single piece of property.

Our law has been sparing in the creation of juristic entities; it has never, for example, taken over the Roman "universitas facti"; [1] and indeed for many years it fumbled uncertainly with the concept of a corporation.[2] One might have supposed that partnership would have been an especially promising field in which to raise up an entity, particularly since merchants have always kept their accounts upon that basis. Yet there too our law resisted at the price of great and continuing confusion; and, even when it might be thought that a statute admitted, if it did not demand, recognition of the firm as an entity, the old concepts prevailed. *Francis v. McNeal,* 228 U.S. 695. And so, even though we might agree that under the influence of the Uniform Partnership Act a partner's interest in the firm should be treated as indivisible, and for that reason a "capital asset" within § 117(a)(1), we should be chary about extending further so exotic a jural concept. Be that as it may in this instance the section itself furnishes the answer. It starts in the broadest way by declaring that all "property" is "capital assets," and then makes three exceptions. The first is "stock in trade * * * or other property of a kind which would properly be included in the inventory"; next comes "property held * * * primarily for sale to customers"; and finally, property "used in the trade or business of a character which is subject to * * * allowance for depreciation." In the face of this language, although it may be true that a "stock in trade," taken by itself, should be treated as a "universitas facti," by no possibility can a whole business be so treated; and the same is true as to any property within the other exceptions. Congress plainly did mean to comminute the elements of a business; plainly it did not regard the whole as "capital assets."

As has already appeared, Williams transferred to the Corning Company "cash," "receivables," "fixtures" and a "merchandise

[1] By universitas facti is meant a number of things of the same kind which are regarded as a whole; e. g. a herd, a stock of wares." Mackeldey, Roman Law § 162.

[2] "To the 'church' modern law owes its conception of a juristic person, and the clear line that it draws between 'the corporation aggregate' and the sum of its members." Pollack & Maitland, Vol. 1, p. 489.

inventory." "Fixtures" are not capital because they are subject to a depreciation allowance; the inventory, as we have just seen, is expressly excluded. So far as appears, no allowance was made for "good-will"; but, even if there had been, we held in *Haberle Crystal Springs Brewing Company v. Clarke, Collector*, 2 Cir., 30 F.2d 219, that "good-will" was a depreciable intangible. It is true that the Supreme Court reversed that judgment—280 U.S. 384—but it based its decision only upon the fact that there could be no allowance for the depreciation of "good-will" in a brewery, a business condemned by the Eighteenth Amendment. There can of course be no gain or loss in the transfer of cash; and, although Williams does appear to have made a gain of $1072.71 upon the "receivables," the point has not been argued that they are not subject to a depreciation allowance. That we leave open for decision by the district court, if the parties cannot agree. The gain or loss upon every other item should be computed as an item in ordinary income.

Judgment reversed.

FRANK, CIRCUIT JUDGE (dissenting in part). I agree that it is irrelevant that the business was once owned by a partnership. For when the sale to the Corning Company occurred, the partnership was dead, had become merely a memory, a ghost. To say that the sale was of the partnership's assets would, then, be to indulge in animism.

But I do not agree that we should ignore what the parties to the sale, Williams and the Corning Company, actually did. They did not arrange for a transfer to the buyer, as if in separate bundles, of the several ingredients of the business. They contracted for the sale of the entire business as a going concern. Here is what they said in their agreement: "The party of the first part agrees to sell and the party of the second part agrees to buy, *all of the right, title and interest* of the said party of the first part *in and to the hardware business* now being conducted by the said party of the first part, *including* cash on hand and on deposit in the First National Bank & Trust Company of Corning in the A. F. Williams Hardware Store account, in accounts receivable, bills receivable, notes receivable, merchandise and fixtures, including two G. M. trucks, good will and all other assets of every kind and description used in and about said business.[3] . . . Said party of the first part agrees not to engage in the hardware business within a radius of twenty-five miles from the City of Corning, New York, for a period of ten years from the 1st day of October 1940."

To carve up this transaction into distinct sales—of cash, receivables, fixtures, trucks, merchandise, and good will—is to do

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3 Emphasis added.

violence to the realities. I do not think Congress intended any such artificial result. In the Senate Committee Report on the 1942 amendment to § 117, it was said: "It is believed that this Senate amendment will be of material benefit to businesses which, due to depressed conditions, have been compelled to dispose of their plant or equipment at a loss. The bill defines property used in a trade or business as property used in the trade or business of a character which is subject to the allowance for depreciation, and real property held for more than six months which is not properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. If a newspaper purchased the plant and equipment of a rival newspaper and later sold such plant and equipment at a loss, such plant and equipment, being subject to depreciation, would constitute property used in the trade or business within the meaning of this section." These remarks show that what Congress contemplated was not the sale of a going business but of its dismembered parts. Where a business is sold as a unit, the whole is greater than its parts. Businessmen so recognize; so, too, I think, did Congress. Interpretation of our complicated tax statutes is seldom aided by saying that taxation is an eminently practical matter (or the like). But this is one instance where, it seems to me, the practical aspects of the matter should guide our guess as to what Congress meant. I believe Congress had those aspects in mind and was not thinking of the nice distinctions between Roman and Anglo-American legal theories about legal entities.

Note

See Murphy, "Sale of a Sole Proprietorship—An Irrationale in Three Parts," 9 Tax L.Rev. 309 (1954); Joseph, "Considerations in Applying the Rule of Williams versus McGowan," 13 Tax L. Rev. 369 (1958).

The rule of *Williams v. McGowan* was in substance approved by the Supreme Court in *Watson v. Commissioner,* 345 U.S. 544, 552 (1953).

BELL'S ESTATE v. COMMISSIONER

Circuit Court of Appeals, Eighth Circuit, 1943. 137 F.2d 454.

SANBORN, CIRCUIT JUDGE. The question for decision is whether, under the Revenue Act of 1936, the consideration received by the life beneficiary of a trust for the transfer of the life interest to the remainderman was ordinary income or was capital.

The facts are agreed to and are as stated in the opinion of the Board of Tax Appeals (now the Tax Court of the United States), 46 B.T.A. 484. It is unnecessary to restate them in detail.

Frederic Somers Bell (now deceased) and Frances Laird Bell, husband and wife, of Winona, Minnesota, on April 28, 1932, each created a trust. The corpus of each trust consisted of 550 shares of the common stock of the Thorncroft Company. The trustees of the Frederic S. Bell trust were Laird Bell, George R. Little, and Willard L. Hillyer. The trustees of the Frances L. Bell trust were Laird Bell, George R. Little, and Frederic S. Bell. Laird Bell is the son of the grantors of the trusts. The trust agreement executed by Frederic S. Bell provided: "The Trustees shall pay to Frances Laird Bell, wife of the Grantor, during her lifetime, the entire net income of the Trust Estate. Upon her death, the Trustees shall pay, deliver, and convey the Trust Estate to Laird Bell, son of the Grantor."

The trust agreement executed by Frances L. Bell provided: "The Trustees shall pay to Frederic Somers Bell, husband of the Grantor, during his lifetime, the entire net income of the Trust Estate. Upon his death, the Trustees shall pay, deliver, and convey the Trust Estate to Laird Bell, son of the Grantor." The shares of stock constituting the corpus of each trust were transferred to the trustees. On February 1, 1936, Frederic S. Bell assigned to Laird Bell "all his [Frederic S. Bell's] right, title and interest in, to and under the trust property held by George R. Little, Frederic Somers Bell and Laird Bell, as Trustees under trust agreement between Frances L. Bell and said Trustees, dated April 28, 1932, in consideration of the receipt of $104,349.26 [cash and securities], paid as hereinafter stated, the receipt whereof is hereby acknowledged." On the same day, Frances L. Bell assigned to Laird Bell "all her right, title and interest, in, to and under the trust property held by Laird Bell, George R. Little and Willard L. Hillyer, as Trustees under trust agreement between Frederic S. Bell and said Trustees, dated April 28, 1932, in consideration of the receipt of $93,060.87 [cash and securities] (being 16.57144% of the agreed value of the trust property), paid as hereinafter stated, the receipt whereof is hereby acknowledged." The consideration delivered by Laird Bell to each of the life beneficiaries represented the value, at the time of the assignments, of their respective life interests, apparently computed upon the basis of a 4% yield on the agreed value of the trust corpus for the life expectancy of each of the life beneficiaries. Laird Bell, having then acquired absolute title to the corpus of each of the trusts, received the trust assets, and the trusts were terminated. In his income tax return for each subsequent year, Laird Bell included the income from the former trust assets.

Frederic S. Bell and Frances L. Bell, in the belief that the consideration which they had received from Laird Bell for the life interests conveyed to him represented the proceeds of a sale of

capital assets,[1] made their respective income tax returns for the year 1936 upon that basis, the return of each of them showing a small capital gain resulting from the sale. The Commissioner of Internal Revenue ruled that the entire consideration received by the life beneficiaries was income under § 22(a) of the Revenue Act of 1936, 49 Stat. 1648.[2] The Board of Tax Appeals affirmed the Commissioner, and the decision of the Board is now before this Court for review.

The Commissioner contends that the consideration received by the life beneficiaries for their respective life interests was in reality an advance payment of future income of the trusts during their life expectancies, and was taxable as ordinary income, even if the son, who acquired the interests, is required to include in his returns all income received by him from the former trust assets. This contention is based mainly upon the opinion of the Supreme Court in *Hort v. Commissioner,* 313 U.S. 28, in which it was held that the amount received by a lessor from a lessee as consideration for the cancellation of a lease was, in effect, a substitute for the future rents reserved in the lease, and was therefore income and not a return of capital. However, there was no transfer of any interest in the lease or of any property involved in that case. The court said (page 32): "* * * The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises."

If the parents of Laird Bell, instead of creating these trusts in 1932, had transferred the stock in the Thorncroft Company to him in consideration of his agreement to pay to each of them annually a certain sum for life, and if, in 1936, he had purchased from them releases of his obligations to make further annual payments, the consideration received by them in 1936 would unquestionably have been income, under the ruling in the *Hort* case. But that is not the situation here. . . .

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1 Revenue Act of 1936, 49 Stat. 1648, 26 U.S.C.A. Int.Rev.Acts, page 873.

"Sec. 117. Capital Gains and Losses

. . . .

"(b) Definition of capital assets. For the purposes of this title, 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business) * * *."

2 Revenue Act of 1936, 49 Stat. 1648, 26 U.S.C.A.Int.Rev.Acts, page 825.

"Sec. 22. Gross Income

"(a) General Definition. 'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income from any source whatever. * * *"

There can be no question that in *Blair v. Commissioner,* [300 U.S. 5], the Supreme Court ruled that assignments of life interests such as those here involved are transfers of interests in the trust assets, and are not merely assignments of income. The Commissioner, however, in seeking for a distinction between that case and these cases, says in his brief: "It is true that in *Blair v. Commissioner,* supra, it was held that the assignment of the right to receive trust income during the life of the assignor carried with it such a property interest in the fund that the transferee and not the transferor was taxable upon future income. But there the assignments were by way of gift and there was no question such as here presented with respect to the taxability of the consideration. As pointed out by the Board of Tax Appeals and as hereinabove indicated, that question is answerable by reference to the *Hort* case, *Hort v. Commissioner,* 313 U.S. 28, where the Court expressly held that simply because the lease was 'property' the amount received for its cancellation was not a return of capital. Similarly, simply because the life interests here may have been property within the scope of the Blair case, it does not follow that the amounts received by the transferors did not constitute ordinary income to them. It is submitted that those amounts were ordinary income in the same sense as prepaid rentals, interest or salaries are ordinary income." . . .

In *Harrison v. Schaffner,* 312 U.S. 579, a life beneficiary of a trust had assigned to her children specified amounts in dollars from her trust income for the year following the assignment. The trustees paid these amounts to the assignees. The Supreme Court, in its opinion holding that the amounts, for tax purposes, remained the income of the assignor, said with respect to *Blair v. Commissioner,* supra (at p. 582): "* * * It is true, as respondent argues, that where the beneficiary of a trust had assigned a share of the income to another for life without retaining any form of control over the interest assigned, this Court construed the assignment as a transfer in praesenti to the donee, of a life interest in the corpus of the trust property and held in consequence that the income thereafter paid to the donee was taxable to him and not the donor. *Blair v. Commissioner,* supra. But we think it quite another matter to say that the beneficiary of a trust who makes a single gift of a sum of money payable out of the income of the trust does not realize income when the gift is effectuated by payment, or that he escapes the tax by attempting to clothe the transaction in the guise of a transfer of trust property rather than the transfer of income where that is its obvious purpose and effect."

The Supreme Court has not, expressly or by implication, overruled or modified its decision in *Blair v. Commissioner,* supra. The assignments in *Helvering v. Horst* [311 U.S. 112], *Helvering*

v. Eubank [311 U.S. 122], and *Harrison v. Schaffner,* supra, are distinguishable from the assignments involved in *Blair v. Commissioner,* supra, and from the assignments involved in the instant cases. The Supreme Court has made the distinction, and it is not for this Court to unmake it. We have already pointed out that *Blair v. Commissioner* does not conflict with *Hort v. Commissioner,* 313 U.S. 28, which involved the extinguishment of a contractual right to future rentals, and not an assignment of an interest in property. See *Shuster v. Helvering,* 2 Cir., 121 F.2d 643, 645.

Our conclusion is that in 1936 Frederic S. Bell and Frances L. Bell did not sell to Laird Bell income or naked rights to receive income, but sold to him life interests in trust property, and that the considerations received by them were not ordinary income, taxable as such, but were the proceeds of sales of capital assets.

Since the Board was of the opinion that the consideration received by each of the life beneficiaries was ordinary income, it expressed no opinion as to the proper basis for determining the amount of capital gain, if any. The parties are not in accord upon that question, and we are asked to decide it. We think the question should first be determined by the Tax Court. See *Hormel v. Helvering,* 312 U.S. 552, 556.

The decision of the Board is reversed, and the cases are remanded for further proceedings not inconsistent herewith.

WOODROUGH, CIRCUIT JUDGE (dissenting). The duty to record minority opinion when it exists is especially urgent in the tax cases and not to be avoided because the questions are close or because of great respect for the opinion of associates. The decisions are of wide interest and are often embodied in general regulations. It may be some indication of close questions in this case that there was very positive dissent from the majority opinion below, and I find myself under the necessity of dissenting from the majority opinion here. I think that the ruling in *Hort v. Commissioner,* 313 U.S. 28, is applicable and controlling in this case rather than that in *Blair v. Commissioner,* 300 U.S. 5 and that implications fairly to be drawn from *Helvering v. Horst,* 311 U.S. 112; *Helvering v. Eubank,* 311 U.S. 122; *Harrison v. Schaffner,* 312 U.S. 579; and *Hort v. Commissioner,* 313 U.S. 28, lend support to the decision below. I would affirm.

Notes

(A) The principal case is noted in 57 Harv.L.Rev. 382 (1944). See also "Taxability of Proceeds of a Right to Income for Life," 56 Yale L.J. 570 (1947).

(B) Other cases to the same effect are *Quigley v. Commissioner,* 143 F.2d 27 (C.C.A.7th, 1944); *McAllister v. Commissioner,*

157 F.2d 235 (C.C.A.2d, 1947); *Allen v. First Nat. Bank & Trust Co.*, 157 F.2d 592 (C.C.A.5th, 1946).

(C) See *Commissioner v. Golonsky,* 200 F.2d 72 (C.A.3d, 1952), where a lessee received a sum from the lessor to surrender the premises before the end of the term. It was held that this was capital gain. *Cf.* the *Hort* case at p. 198, above.

BELL v. HARRISON

Court of Appeals, Seventh Circuit, 1954. 212 F.2d 253.

MAJOR, CHIEF JUDGE. Each of these appeals presents for decision the same question and the cases have been consolidated, as they were in the district court. The sole issue is whether plaintiff, having purchased two life estates for which he admittedly paid full and fair value, measured by the life expectancies of the respective sellers, is entitled to recover his cost through amortization over the periods of the life expectancies, i. e., by ratable annual deductions from the amounts received by him each year subsequent to such purchases. . . .

Briefly, the actions were brought to recover federal income taxes allegedly overpaid by plaintiff for the years 1936 to 1941, both inclusive. On April 28, 1932, plaintiff's father and mother created reciprocal trusts, each making the other a life beneficiary with remainder over to the plaintiff (taxpayer). On February 1, 1936, the latter purchased the respective life estates of his parents. At that time the value of the corpus of the trust created by his father was $561,573.84, the value of his mother's life estate therein was $93,060.87, the value of the corpus of the trust created by his mother was $561,546.69, and the value of his father's life estate therein was $104,349.26. Plaintiff paid to his father and mother respectively the value of their life estates. The corpus of both trusts consisted of corporate stock which was delivered to the plaintiff upon purchase, some of which was subsequently transferred to his children as a gift.

We think this brief statement is sufficient as a premise for the controverted issue. Plaintiff contends that he made a capital expenditure and acquired a capital asset or right which was wasting in value with time and, regardless of the fact that he was the remainderman, that he was entitled to recover the amount of his capital expenditure—his cost basis—by amortization over the life expectancies of his parents, that is, by ratable annual deductions from the amounts received by him each year as income as the result of his purchase. On the other hand, defendant (the government) contends that the purchase by plaintiff, the remainderman, of the life interest of his parents resulted in a merger of the two estates, particularly in view of the fact that plaintiff evidenced no intent to preserve the two interests separate and dis-

tinct. Upon this basis it is argued that for tax purposes there was no life interest to amortize after the merger and that the capital invested in the purchase of the life interest can be recouped only at the time of sale or other disposition by way of being added to the cost basis of such property.

The government's contention is bottomed entirely upon this premise of merger which it is insisted destroyed the right which plaintiff as the purchaser of the life estate of his parents would otherwise have had, to amortize the amounts paid over the period of the life expectancies of his parents. At any rate, we so understand this to be the position of the government because it is conceded that plaintiff would have been entitled to such treatment taxwise, absent the fact that he was the remainderman named in the trusts. In other words, if these life interests had been purchased by a third party, there would be no question but that such party would be entitled to amortization.

A study of the cases reveals that the problem before us is difficult of solution, although the weight of authority, such as it is, sustains plaintiff's contention. In *Elmer J. Keitel v. Commissioner,* 15 B.T.A. 903, the facts, without reciting them, are sufficiently similar to those of the instant case to raise the same legal problem. The court, in deciding the issue in favor of the taxpayer, stated, 15 B.T.A. at page 907: "Where, as in this proceeding, the personal property is reproductive, the holder of the life interest does not possess the right to consume it and is entitled only to its use and income. So that what petitioner purchased was the right to use his mother's interest during her life or widowhood. The fact that petitioner owned a remainder interest in part of what he so purchased does not affect the question here presented. * * * What he purchased, and that is all that concerns us, was a terminable estate and the termination of the estate will end all that he purchased." The court then discussed and compared the situation to that of the purchaser of a lease and stated, 15 B.T.A. at page 907: "Nor can we perceive any difference in this respect between the purchase of a lease of a life interest and the purchase of the life interest itself. In both cases the interest is terminable and exhaustible for income-tax purposes."

This decision and reasoning of the Board of Tax Appeals (now the Tax Court) has been approvingly cited by that court in a number of subsequent cases. *Bell v. Commissioner,* 46 B.T.A. 484, 490; *Wolff v. Commissioner,* 7 T.C. 717, 721; *Penn v. Commissioner,* 16 T.C. 1497, 1500. In the *Wolff* case, the court stated: "Had petitioner paid to her stepmother the purchase price of the latter's life estate in a lump sum, the amount represented thereby would have constituted an investment in a capital asset, ex-

haustible and therefore recoverable through deduction over the life of the asset acquired, that is, the life expectancy of the stepmother."

In the *Bell* case the Board of Tax appeals considered the treatment to be accorded the mother of the instant plaintiff on account of the sale of his life interest in his wife's trust, being one of the trusts involved in the present proceeding. The Board held that the gain realized on such sale was to be taxed at capital gains rates and in doing so stated, 46 B.T.A. at page 490: "On the other hand the vendee of a life estate has a capital investment exhaustible by charges against income over its duration. [Citing cases, including the *Keitel* case.] That this purchaser [referring to petitioner in the instant case] happened also to be the remainderman can not affect the principle and may even lack significance." It is asserted by the government that this statement by the Board was dictum. Assuming such to be the case, we think it is entitled to some consideration, particularly in view of the fact that it relates to the precise question here to be decided.

So far as we are aware, there are no cases which have considered the question here presented other than those which we have cited and, as noted, they have held adverse to the government's contention. Both sides, however, cite and rely upon the so-called lease cases, wherein the courts have considered the tax treatment to be accorded a purchaser, usually a landlord or property owner, of an outstanding lease. We have previously quoted from *Keitel v. Commissioner* a statement by the Board of Tax Appeals, where the purchaser of a lease and the purchaser of a life interest were placed in the same category for tax purposes. It appears that the Board of Tax Appeals (now the Tax Court) has with one possible exception, subsequently noted, adhered to the position that the purchaser is entitled to recover by way of amortization the amount paid a lessee for the cancellation of a lease. *Henry B. Miller v. Commissioner,* 10 B.T.A. 383; *Charles B. Bretzfelder v. Commissioner,* 21 B.T.A. 789; *Harriet B. Borland v. Commissioner,* 27 B.T.A. 538; *Manhattan Life Ins. Co. v. Commissioner,* 28 B.T.A. 129, modified on other grounds, *Helvering v. Manhattan Life Ins. Co.,* 2 Cir., 71 F.2d 292, and *Berger v. Commissioner,* 7 T.C. 1339. . . .

The principal cases relied upon by the government in support of its merger theory are *Boos v. Commissioner,* 30 B.T.A. 882; *Citizens Nat. Bank v. Commissioner,* 8 Cir., 122 F.2d 1011, 1014; *Wells Fargo Bank & Union Trust Co. v. Commissioner,* 9 Cir., 163 F.2d 521, 523, and *W. D. Haden Co. v. Commissioner,* 5 Cir., 165 F.2d 588. The *Boos* case is the exception heretofore noted to the line of the Tax Court cases which have ignored or refused to sustain the merger theory as a basis for decision. The exception, however, is more fanciful than real. There, the taxpayer paid

$25,000 for a 99-year lease, with an option to purchase. Seven months later the taxpayer purchased the fee for $55,000. The Board, evidently looking at the substance rather than the form of the transaction, held that upon purchase of the fee the leasehold interest merged therewith and refused to permit the amortization of the purchase price of the lease, which still had some 98 years to run.

In the *Citizens National Bank* case, neither the question for decision nor the facts bear any similarity to those of the instant case. There, the taxpayer was attempting to deduct as rental, monthly payments which it made pursuant to a contract with a person who relinquished a life interest in 1920, and who at that time had an expectancy of 13.47 years. As we understand the case, no attempt was made to amortize the purchase price of the life interest, and evidently any attempt to have done so in 1936, long after the expiration of the life expectancy, would have been futile. The gist of the decision is that the taxpayer was not entitled to claim the payments made under a contract as rental at a time when it was as a matter of fact the owner of the property. That being the situation, the court stated that the question of merger was immaterial. . . .

Thus, the only cases which have considered the precise question here in issue are favorable to the taxpayer, although it must be admitted that they are not numerous and that their weight is open to some question. However, the principle involved is closely analogous to that considered in the so-called lease cases which are overwhelmingly opposed to the government's contention.

The judgment in each case is

Affirmed.[1]

Notes

(A) Was the government sound in pitching its argument entirely on the "merger" theory? Are there any other arguments that might be advanced on behalf of the government's position?

Bell v. Harrison was followed and applied by the Tax Court in *William N. Fry, Jr.*, 31 T.C. 522 (1958). For discussion of the general question, see Nims, "Sale of a Life Estate," 45 A.B.A.J. 183 (1959).

(B) The taxpayer bought a remainder in 1936. This remainder becomes more valuable year by year as the life tenant's expectancy runs out. How is this increment in value taken into account for tax purposes? Do the two cases taken together suggest an advantageous way to buy property? For general consideration, see Plumb, "Tax Effects of Sales of Life Interests in Trusts—How to Eat Your Cake and Have It," 9 Tax L.Rev. 39 (1953).

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[1] There is a comment on this case in 68 Harv.L.Rev. 548 (1955).

COMMISSIONER v. P. G. LAKE, INC.

Supreme Court of the United States, 1958. 356 U.S. 260.

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

We have here, consolidated for argument, five cases involving an identical question of law. Four are from the Tax Court whose rulings may be found in 24 T.C. 1016 (the *Lake* case), 24 T.C. 818 (the *Fleming* case), 24 T.C. 1025 (the *Weed* case). (Its findings and opinion in the *Wrather* case are not officially reported.) Those four cases involved income tax deficiencies. The fifth, the *O'Connor* case, is a suit for a refund originating in the District Court. 143 F.Supp. 240. All five are from the same Court of Appeals, 241 F.2d 71, *id.,* p. 65, *id.,* p. 78, *id.,* p. 84, *id.,* p. 69. The cases are here on petitions for certiorari which we granted because of the public importance of the question presented. 353 U.S. 982.

The facts of the *Lake* case are closely similar to those in the *Wrather* and *O'Connor* cases. Lake is a corporation engaged in the business of producing oil and gas. It has a seven-eighths working interest [1] in two commercial oil and gas leases. In 1950 it was indebted to its president in the sum of $600,000 and in consideration of his cancellation of the debt assigned him an oil payment right in the amount of $600,000, plus an amount equal to interest at 3 percent a year on the unpaid balance remaining from month to month, payable out of 25 percent of the oil attributable to the taxpayer's working interest in the two leases. At the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years. It did in fact pay out in a little over three years.

In its 1950 tax returns Lake reported the oil payment assignment as a sale of property producing a profit of $600,000 and taxable as a long-term capital gain under § 117 of the Internal Revenue Code of 1939. The Commissioner determined a deficiency, ruling that the purchase price (less deductions not material here) was taxable as ordinary income, subject to depletion. The *Wrather* case has some variations in its facts. In the *O'Con-*

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1 An oil and gas lease ordinarily conveys the entire mineral interest less any royalty interest retained by the lessor. The owner of the lease is said to own the "working interest" because he has the right to develop and produce the minerals.

In Anderson v. Helvering, 310 U.S. 404, we described an oil payment as "the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced." Id., at 410. A royalty interest is "a right to receive a specified percentage of all oil and gas produced" but, unlike the oil payment, is not limited to a specified sum of money. The royalty interest lasts during the entire term of the lease. Id., at 409.

nor case the assignors of the oil payments owned royalty interests [2] rather than working interests. But these differences are not material to the question we have for decision.

The *Weed* case is different only because it involves sulphur rights, rather than oil rights. The taxpayer was the owner of a pooled overriding royalty in a deposit known as Boling Dome.[3] The royalty interest entitled the taxpayer to receive $0.00966133 per long ton of sulphur produced from Boling Dome, irrespective of the market price. Royalty payments were made each month, based on the previous month's production.

In 1947, the taxpayer, in order to obtain a sure source of funds to pay his individual income taxes, agreed with one Munro, his tax advisor, on a sulphur payment assignment. The taxpayer assigned to Munro a sulphur payment totaling $50,000 and consisting of 86.254514 percent of his pooled royalty interest, which represented the royalty interest on 6,000,000 long tons of the estimated remaining 21,000,000 long tons still in place. The purchase price was paid in three installments over a three-year period. Most of the purchase price was borrowed by Munro from a bank with the sulphur payment assignment as security. The assigned sulphur payment right paid out within 28 months. The amounts received by the taxpayer in 1948 and 1949 were returned by him as capital gains. The Commissioner determined that these amounts were taxable as ordinary income, subject to depletion.

The *Fleming* case is a bit more complicated and presents an additional question not in the other cases. Here oil payment assignments were made, not for cash but for real estate. Two transactions are involved. Fleming and others with whom he was associated made oil payment assignments, the rights and interests involved being held by them for productive use in their respective businesses of producing oil. Each oil payment was assigned for an interest in a ranch. Each was in an amount which represented the uncontested fair value of the undivided interest in the ranch received by the assignor, plus an amount equal to the interest per annum on the balance remaining unpaid from time to time. The other transaction consisted of an oil payment assignment by an owner of oil and gas leases, held for productive use in the assignor's business, for the fee simple title to business real estate. This oil payment assignment, like the ones mentioned above, was in the amount of the uncontested

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2 See note 1, supra.

3 Boling Dome is a tract composed of various parcels of land. The owners of the royalty interests in sulphur produced from the separate parcels entered into a pooling agreement by which royalties from sulphur produced anywhere in Boling Dome were distributed pro rata among all the royalty interest holders. In that sense was the interest of each "pooled."

fair market value of the real estate received, plus interest on the unpaid balance remaining from time to time.

First, as to whether the proceeds were taxable as long term taxable gains under § 117 [4] or as ordinary income subject to depletion. The Court of Appeals started from the premise, laid down in Texas decisions, see especially *Tennant v. Dunn,* 130 Tex. 285, 110 S.W.2d 53, that oil payments are interests in land. We too proceed on that basis; and yet we conclude that the consideration received for these oil payment rights (and the sulphur payment right) was taxable as ordinary income, subject to depletion.

The purpose of § 117 was "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." See *Burnet v. Hormel,* 287 U.S. 103, 106. And this exception has always been narrowly construed so as to protect the revenue against artful devices. See *Corn Products Refining Co. v. Commissioner,* 350 U.S. 46, 52.

We do not see here any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. The pay-out of these particular assigned oil payment rights could be ascertained with considerable accuracy. Such are the stipulations, findings, or clear inferences. In the *O'Connor* case, the pay-out of the assigned oil payment right was so assured that the purchaser obtained a $9,990,350 purchase money loan at 3½ percent interest without any security other than a deed of trust of the $10,000,000 oil payment right, he receiving

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[4] Section 117(a)(1) provides in relevant part:

"The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale .to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1) . . . or real property used in the trade or business of the taxpayer." 53 Stat. 50, as amended, 56 Stat. 845.

Section 117(a) (4) provides:

"The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income." 53 Stat. 51, as amended, 56 Stat. 843.

Section 117(b) provides:

"In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

"100 per centum if the capital asset has been held for not more than 6 months;

"50 per centum if the capital asset has been held for more than 6 months." 53 Stat. 843.

4 percent from the taxpayer. Only a fraction of the oil or sulphur rights were transferred, the balance being retained.[5] Except in the *Fleming* case, which we will discuss later, cash was received which was equal to the amount of the income to accrue during the term of the assignment, the assignee being compensated by interest on his advance. The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

These arrangements seem to us transparent devices. Their forms do not control. Their essence is determined not by subtleties of draftsmanship but by their total effect. See *Helvering v. Clifford*, 309 U.S. 331; *Harrison v. Schaffner*, 312 U.S. 579. We have held that if one, entitled to receive at a future date interest on a bond or compensation for services, makes a grant of it by anticipatory assignment, he realizes taxable income as if he had collected the interest or received the salary and then paid it over.

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5 Until 1946 the Commissioner agreed with the contention of the taxpayers in these cases that the assignment of an oil payment right was productive of a long-term capital gain. In 1946 he changed his mind and ruled that "consideration (not pledged for development) received for the assignment of a short-lived in-oil payment carved out of any type of depletable interest in oil and gas in place (including a larger in-oil payment right) is ordinary income subject to the depletion allowance in the assignor's hands." G.C.M. 24849, 1946–1 Cum.Bull. 66, 69. This ruling was made applicable "only to such assignments made on or after April 1, 1946." I.T. 3895, 1948–1 Cum.Bull. 39. In 1950 a further ruling was made that represents the present view of the Commissioner. I.T. 4003, 1950–1 Cum.Bull. 10, 11, reads in relevant part as follows:

"After careful study and considerable experience with the application of G.C.M. 24849, supra, it is now concluded that there is no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights. It is, therefore, the present position of the Bureau that the assignment of any in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income from such property interest. Therefore, the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him. Where the assignment of the in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises.

"Notwithstanding the foregoing G.C.M. 24849, supra, and I.T. 3935, supra, do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property."

The pre-1946 administrative practice was not reflected in any published ruling or regulation. It therefore will not be presumed to have been known to Congress and incorporated into the law by re-enactment. See Helvering v. N. Y. Trust Co., 292 U.S. 455, 467–468. Cf. United States v. Leslie Salt Co., 350 U.S. 383, 389–397. Moreover, prior administrative practice is always subject to change "through exercise by the administrative agency of its continuing rule-making power." See Helvering v. Reynolds, 313 U.S. 428, 432.

That is the teaching of *Helvering v. Horst,* 311 U.S. 112, and *Harrison v. Schaffner, supra;* and it is applicable here. As we stated in *Helvering v. Horst, supra,* 117, "The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them." There the taxpayer detached interest coupons from negotiable bonds and presented them as a gift to his son. The interest when paid was held taxable to the father. Here, even more clearly than there, the taxpayer is converting future income into present income.

Second, as to the *Fleming* case. The Court of Appeals in the *Fleming* case held that the transactions were tax-free under § 112(b)(1) which provides:

> "No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment." 53 Stat. 37.

In the alternative and as a second ground, it held that this case, too, was governed by § 117.

We agree with the Tax Court, 24 T.C. 818, that this is not a tax-free exchange under § 112(b)(1). Treasury Regulations 111, promulgated under the 1939 Act, provide in § 39.112(b)(1)-1 as respects the words "like kind," as used in § 112(b)(1), that "One kind or class of property may not . . . be exchanged for property of a different kind or class." The exchange cannot satisfy that test where the effect under the tax laws is a transfer of future income from oil leases for real estate. As we have seen, these oil payment assignments were merely arrangements for delayed cash payment of the purchase price of real estate, plus interest. Moreover, § 39.112(a)-1 states that the "underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated." Yet the oil payment assignments were not conversions of capital investments, as we have seen.

Reversed.

Note

See Benjamin and Currier, "The Supreme Court and Taxation of Oil, Gas and Production Payments: The Lake Cases," 19 Louisiana L.Rev. 579 (1959).

In *Eugene T. Flewellen,* 32 T.C. 317 (1959), the court held that the donor of sums due and uncollected from already produced

gas and oil, and of a dollar amount out of future oil royalty payments, to tax exempt charities, was taxable on the income involved.

Gain on the sale of tax exempt securities is subject to the federal income tax. *Willcuts v. Bunn*, 282 U.S. 216 (1931). See also *United States v. Stewart*, 311 U.S. 60 (1940). But where state or municipal bonds are originally issued at a discount, The Treasury treats the "original issue" discount as part of the interest, and as not taxable when subsequently realized on sale or redemption. I. T. 2629, XI–1 Cum.Bull. 20 (1932). See also Rev.Rul. 60–210, 1960–1 Cum.Bull. ——.

CHAPIN v. COMMISSIONER

United States Court of Appeals, Second Circuit, 1959. 271 F.2d 856.

PER CURIAM. In 1938 and 1939 Harrison L. Chapin purchased ten single premium ten-year endowment policies on the lives of his children and one son-in-law. These policies were purchased with funds obtained by a bank loan. Until 1942 Chapin deducted from his gross income on his income tax returns the annual interest paid on the borrowed funds. However, beginning with the year 1942 section 24(a)(6) of the 1939 Revenue Code was in effect, and this section disallows deduction for interest paid on funds borrowed to purchase single premium life and endowment policies.[1] Thus for the years 1942 through 1949 Chapin was permitted no deduction on his annual returns for interest paid annually to the bank. When the policies matured in 1948 and 1949 the Commissioner determined that the amount by which the proceeds then received exceeded the premiums paid in 1938 and 1939 constituted ordinary income.

The taxes determined by the Commissioner to be payable were paid. . . . Upon the above stipulated facts the district court dismissed the action. This appeal followed. Appellants make two contentions. First, they contend that the interest payments, inasmuch as these payments could not have been deducted annually, should be considered as part of the cost of the policies in determining Chapin's gain. Second, they contend that any gain, i. e., any difference between Chapin's payments and the policy proceeds, however computed, and whether including interest payments, should be treated as a long-term capital gain rather than as ordinary income. These contentions will be considered in that order.

Section 22(b)(2)(A) of the 1939 Code, provides that the amount by which the proceeds received under a life insurance

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[1] [Now found in sec. 264 of the 1954 Code. Ed.]

or endowment contract (other than amounts paid by reason of the death of the insured) exceed the "aggregate premiums or consideration paid" is to be included within gross income. Despite the ingenuity of the contentions appellant has presented to this court, we cannot escape the conclusion that (1) interest payments to a bank for funds borrowed to purchase an endowment policy are not part of the consideration paid for that policy under 22(b)(2)(A), and that (2) the express provisions of section 22(b)(2)(A) are not impliedly superseded by other sections of the Code. Hence we affirm the lower court action in disallowing the interest payments as part of the cost of the policies.

There remains the contention that the difference between the premiums and the proceeds constitutes long term capital gain rather than ordinary income. This contention was considered by the Ninth Circuit and rejected. *Avery v. Commissioner,* 9 Cir., 1940, 111 F.2d 19. The *Avery* case was followed by this court in *Blum v. Higgins,* 2 Cir., 1945, 150 F.2d 471, 474. We follow these cases.

Judgment affirmed.

Notes

(A) Would it have made any difference in the principal case if the contract had been sold to a third person just before maturity rather than being held and paid off by the insurance company? Would there have been a capital asset? In *Commissioner v. Phillips,* 275 F.2d 33 (C.A.4th, 1960), the taxpayer sold an endowment policy to his partner, just before its maturity. The Court of Appeals held, reversing the Tax Court, that the gain was taxable as ordinary income. See Wiley, "The Sale of an Endowment Policy," 36 Taxes 803 (1958). See also Bechly, "Sale of a Contract—Capital Gain or Ordinary Income," 35 Taxes 759 (1957).

(B) *"Investment" contracts.* In *Caulkins v. Commissioner,* 144 F.2d 478 (C.A.6th, 1944), it appeared that the taxpayer had purchased an "investment certificate," under which he made certain monthly payments, and the company issuing the certificate agreed to pay him $20,000 at the end of ten years if his payments were duly made. After ten years, the taxpayer surrendered his certificate and received $20,000. His payments had aggregated $15,043. The court held that the gain was taxable as a capital gain.

In Rev.Rul. 55–136, 1955–1 Cum.Bull. 213, the Treasury expressed its disapproval of the *Caulkins* case. See also Rev.Rul. 56–77, 1956–1 Cum.Bull. 620. In *Commissioner v. Morgan,* 272 F.2d 936 (C.A.9th, 1959), involving a slightly different question, the court disapproved of the *Caulkins* case and declined to follow it. See also *Fisher v. Commissioner,* 209 F.2d 513 (C.A.6th, 1954).

This question is probably now covered by sec. 1232(a)(2) of the 1954 Code, and sec. 72 (see especially sec. 72(*l*)). Note, though, that these provisions are not applicable to contracts

issued prior to January 1, 1955. Thus the problem remains as to older contracts which may hereafter mature or be redeemed.

(C) *Partnership interests.* The rule for the sale of partnership interests is now prescribed by secs. 741 and 751 of the 1954 Code. See also secs. 1.741–1 and 1.751–1 of the Income Tax Regulations. The questions are discussed in Willis, "Taxation under the 1954 Code of Gain on Sale of a Partnership Interest," 4 U.C.L.A.L.Rev. 38 (1956), now included in Chapters 14–18 (pages 178–279) of Willis, Handbook of Partnership Taxation (1957). Note that the problem in connection with the sale of a partnership interest arises from the fact that the interest may include certain items which are essentially income, such as uncollected fees in a law partnership, or inventory items which have appreciated in value. Does sec. 751 of the Code adequately take care of the problem?

(D) *Agency or dealers contracts.* Compare *Jones v. Corbyn,* 186 F.2d 450 (C.A.10th, 1950). In that case the taxpayer held an insurance agency under a contract with the insurance company. The company desired to terminate the agency, and paid a lump sum to the taxpayer in return for cancellation of the agency contract. The court held that the contract was a capital asset, that the termination of the contract was a sale, and that the amount received by the taxpayer was taxable as a capital gain. See also *Louis W. Ray,* 18 T.C. 438 (1952).

See sec. 1241 of the 1954 Code which provides for capital gain or loss in such cases.

(E) *Entertainers and entrepeneurs.* Can an entertainer "incorporate" himself, and then sell the stock at a capital gain—thus in effect capitalizing his future earnings, and realizing the amount at capital gain rates? See *Jack Benny,* 25 T.C. 197 (1955), where this was successfully done. The taxpayer and others formed a corporation which contracted with a sponsor to produce a radio show. The taxpayer and the others later sold their stock to the X Broadcasting System. It was held that the gain was taxable as a capital gain. The Government took an appeal from this decision, but it was later dismissed on stipulation.[1]

CHANDLER v. UNITED STATES

United States Court of Appeals, Seventh Circuit, 1955. 226 F.2d 403.

FINNEGAN, CIRCUIT JUDGE. A clear-cut question is before us, arising from lengthy facts, requiring interpretation and application of former § 117, Internal Revenue Code of 1939. We must decide if, during the calendar years 1942 to 1950, taxpayer sold statutory capital assets. To reach our ultimate disposition of these appeals we consider if taxpayer engaged in the real estate business during that period and whether the lands involved con-

[1] For discussions, see Kragen and Barton, "The Tax Dilemma of the Entertainer," 31 So.Calif.L.Rev. 390 (1958); "The Commissioner and Mr. Benny," 1 Stanford L.Rev. 700 (1949); Mintz, "Entertainers and the Capital Gain Tax," 4 Tax L.Rev. 275 (1949).

stituted property held by taxpayer primarily for sale to customers in the ordinary course of trade or business within the ambit of § 117.

Only a distilled version of the facts need be reported since *Chandler v. United States,* D.C.N.D.Ill.1954, 121 F.Supp. 722, reflects considerable detailing of the record made below, on a stipulation of certain facts, some documentary evidence and testimony—largely uncontradicted. Capitol Freehold Land Trust succeeded to the title of approximately one million acres of Texas land. In the beginning, 1882 to 1888, the State of Texas conveyed some 3,000,000 acres of land to a British corporation, Capitol's earliest predecessor in title. These transfers were consideration for constructing the Texas State Capitol building at Austin. Another trust, created June 4, 1915, held title to all the remaining portions of the principal tract until December 23, 1933, when Capitol took over its titles.

Activities of these trusts, according to the District Judge's memorandum, 121 F.Supp. 723, were shown as, and by:

"An agreed tabulation from the books and records, or annual reports, of the trustees reflects that from 1915 through 1932 over 700,000 acres of land were sold for approximately $10,747,-000; that from 1933 through 1941 over 187,000 acres were sold at approximately $1,291,000; and that from 1942 through 1950 over 290,000 acres were sold for approximately $5,000,000. During the period from 1942 through 1950 there were at least 536 separate sales transactions, or an average of 59 per year."

The declarations of trust contained these pertinent provisions:

The 1915 Trust:

"As soon as practicable without in the opinion of the Trustees sacrificing values the Trustees shall convert the entire trust estate into money notes or bonds or partly one or partly the other or others and distribute the same among certificate holders. It is the expectation and desire of the parties hereto that all of the lands belonging to the trust estate situated in Texas shall be converted into money within 10 years from this date unless this will in the judgment of the Trustees involve an unreasonable sacrifice but in any event it shall be the duty of the Trustees to have the trust hereby created completely settled and determined within 15 years from and after the date of this deed." (Stipulation of facts, T.R. 34.)

The 1933 Trust:

"The object of this trust is to administer the trust estate in such manner as to produce as large dividends to the Shareholders as is consistent with sound business practices without in the

judgment of the Trustees endangering the safety of the trust estate and to convert the trust estate into personal property including moneys, notes, bonds, stocks, mortgages, certificates of beneficial interest in trusts or partly one and partly others and to distribute the same as ordinary or liquidating dividends among the Shareholders before the trust expires by its terms." (Exhibit 1.)

The Commissioner of Internal Revenue taxed as ordinary income, gains realized by taxpayer, on land sales, from 1942 to 1950, inclusive. Having paid the assessed taxes, taxpayer sued for a refund on the theory that these gains should have been taxed as long-term capital gains. The District Judge rejected taxpayer's contentions and entered judgment for defendants in the three cases consolidated for trial. D.C., 121 F.Supp. 722.

Though the District Judge made findings of fact, conclusions of law and filed a memorandum, Rule 52, Fed.Rules Civil Proc., 28 U.S.C.A., we are empowered to overturn his decision since the ultimate finding on which the judgment appealed rests is a conclusion of law, or a mixed one. *Fritz v. Jarecki,* 7 Cir., 1951, 189 F.2d 445.

Tax law is littered with cases manifesting the constant struggle to capture the preferred treatment accorded capital gains and losses in contrast to ordinary income and loss transactions. Ascertainment of the definitive characteristics of a capital asset in a given factual situation, is one of the more substantial zones of difficulty. See e. g., Surrey and Warren, Federal Income Taxation, 519 (1955); Miller, The "Capital Asset" Concept: A Critique of Capital Gains Taxation, 59 Yale L.J. 837, 1057 (1950). In deceptively simple words § 117(a)(1) defined capital assets[4] as property held by the taxpayer, whether or not used in his trade or business, with the exception of several enumerated statutory exclusions of which this is a pertinent one:[5] "* * * property held by the taxpayer primarily for sale to *customers* in the *ordinary* course of his trade or business * * *"* From its completion of the capitol building, at Austin, until sometime in 1912, taxpayer engaged in the cattle-

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[4] Section 1221 of the Internal Revenue Code of 1954, 26 U.S.C.A., is based upon this section. But section 1237, I.R.C. 1954, concerning real property subdivided for sale is a new provision. See S.R.No.1622, 83d Cong., 2d Sess. 441 (1954), where the Committee on Finance stated: "It is a new section which permits an individual who is not otherwise a real-estate dealer (as the result of his engaging in the business of selling other real property to customers) to dispose of a tract of real property, held for investment purposes, by subdividing it without necessarily being treated as a real-estate dealer with respect to all of his long term gain."

[5] U.S.Treas.Reg. 111, § 29.117-1.

* Italics supplied.

ranching business[6] on a large scale. D.C., 121 F.Supp. 722, stipulation of facts, T.R. 22. That business activity was abandoned upon becoming financially unsuccessful; the live stock was sold—(stipulation, T.R. 23), and it was then decided that the land holdings should be liquidated. Indeed government counsel stated[7] during the trial below: "Maybe I can save time. We can concede the taxpayer here was liquidating, that it was under a duty to liquidate in accordance with the trust instrument." We would assume from the continuity of testimony appearing in the record just prior to that concession, that counsel referred to the trust created December 23, 1933. The short of it is under defendants' theory, taxpayer liquidated by embarking its capital on a full-scale real estate business, and we add,—using the residue from the vast tract first acquired as compensation for services rendered Texas. Implementing that argument, defendants point to the piece-meal conversion and diminution of land holdings, for profit, as manifesting taxpayer's operation of a realty business. Of course, it is abundantly clear that this taxpayer started with a capital asset. Resort to dictionary definitions of such words as "ordinary," "trade" and "business," as expected, are little aid here. Nor can any workable formula be developed which will show what quantum of commercial activity equals "business." Moreover, "liquidation" is, also, devoid of any magical meaning. Here the taxpayer desired to replace acreage with cash. The lands were not purchased in one market for the purpose of selling holdings in another. There is a consistent history, traced in the record, of an aim to realize on the lands held, compelling adherence to our earlier decision reported as *Three States Lumber Co. v. Commissioner,* 7 Cir., 1946, 158 F.2d 61. There, the Commissioner sponsored a theory[8] remarkably similar to his present position, and we rejected it. Disposition of these lands was consistent with the provisions already quoted from the several successive trust instruments.

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6 "The State of Texas * * * issued to The Capitol Freehold Land and Investment Company, Limited, the original predecessor in interest and title of the lands in question, a Permission to do Business in the State of Texas, to the extent and for the purposes as follows, to-wit: 'the raising, buying and selling of live stock'. * * *" Stipulation, T.R. 24.

7 T.R. 184. See also defendants' brief, pp. 6 ff, pp. 24 ff.

8 Summarizing his argument and position taken in Three States Lumber Co. v. Commissioner of Internal Revenue, 7 Cir., 1946, 158 F.2d 61, the Commissioner stated on page 5 in the brief he there filed:

"After terminating its lumber business the taxpayer for many years engaged in the business of dividing and selling its 17,000 acres of land. It is quite immaterial that its motive in doing so was the desire to liquidate. The statute which provides that 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,' shall not constitute capital assets, does not require that the property must have been acquired originally for resale to customers, or that a taxpayer must also indulge in *buying* property during the period in which it holds already acquired property for sale." (Italicization appears in original.)

Had the lands been sold in a single unit there probably would have been slight debate concerning their capital asset status. But the market place is hardly glutted with prospective buyers clamoring for million acre tracts. It seems odd to penalize this taxpayer because it actively sought to dispose of these holdings. Defendant would insist that Capitol sit idle, wishing for a buyer or buyers, under the threat that any selling effort would result in deprivation of capital asset treatment. Despite the blurring, in relevant precedent, between capital gain and ordinary income we think the specific facts established in this case warrant capital gain treatment for taxpayer's transactions. That taxpayer indicated in a 1942 protest to an Internal Revenue Agent, it was a dealer in real property is hardly determinative of the total appeal. Self-description, such as that, in the setting of this case is well wide of the mark and but a speck on the periphery.

The District Court's judgment, appealed, is reversed.

Notes

"held . . . for sale to customers"

(A) What are the tests for determining when property is "held . . . for sale to customers"? In *Hollis v. United States,* 121 F.Supp. 191 (N.D.Ohio, 1954) it appeared that an authority on Far Eastern art went to Japan in 1946 for service with the Arts and Monuments Division of the Allied Forces in Japan. While there he acquired a number of art objects, which he shipped to his home. There was no advertising and no published price lists, but he sold nearly all of the objects to museums and collectors. It was held that the gain was taxable as ordinary income.

Suppose the same man had purchased an object and kept it in his home as a decoration for twenty years. If he had then sold it, how would the gain be taxed?

(B) Cf. *Estate of Jacques Ferber,* 22 T.C. 261 (1954), where it appeared that a retail dealer in furs died. (Any income he derived from sale of furs would clearly be taxable as ordinary income.) After his death, his executors sold the furs on hand in bulk and at auction. It was held that the furs held by the executors were capital assets and produced capital gains. The Treasury has acquiesced in this decision. 1954–2 Cum.Bull. 4.

(C) In 1942, an automobile dealer took 28 of his 327 new cars, and assigned them for use in his business as demonstrators, courtesy cars, and so on. He sold these cars after the war. Is the gain taxable as ordinary income or as capital gain? See *W. R. Stephens Co. v. Commissioner,* 199 F.2d 665 (C.A.8th, 1952). The Treasury's views on this question are amplified in Rev.Rul. 60–15, 1960–1 Cum.Bull. ——.

(D) A number of cases have arisen concerning housing projects or real estate developments undertaken during and after the war. In many cases, these projects were built for rental purposes. Eventually, some or all of the property was sold. Is the gain taxable as a capital gain, or as ordinary income? In each case

the question is: Is the property held primarily for rental or "for sale to customers"? See *Dougherty v. Commissioner*, 216 F.2d 110 (C.A.6th, 1954).

"used in the trade or business"

(E) What is the meaning of "used in the trade or business"? Suppose a lawyer owns an apartment house. Is the property a capital asset? See *Fackler v. Commissioner*, 133 F.2d 509 (C.C. A.6th, 1943); sec. 1.1221–1(b) of the Income Tax Regulations. The problems are excellently discussed in Miller, "The 'Capital Asset' Concept: A Critique of Capital Gains Taxation," 59 Yale L.J. 837, 1057 (1950). See also "The Single Rental as a 'Trade or Business' Under the Internal Revenue Code," 23 U. of Chi.L.Rev. 111 (1955); "When Is Real Estate Held for the Production of Income Used in the Trade or Business of the Taxpayer?" 59 Harv.L.Rev. 119 (1945).

Dealers in securities or real estate

(F) Note the special provision in sec. 1236 (new in the 1954 Code) with respect to dealers in securities. Under this provision, such a dealer may have investment assets, on which he receives capital gain treatment, if he follows the requirements for earmarking and separation spelled out in this provision of the statute.

Can a dealer in real estate hold land for investment purposes? How should he earmark or segregate it? See Emmanuel, "Capital Gains for Real Estate Operators," 12 U. of Fla.L.Rev. 280 (1959); Weissbourd, "Tax Planning in Real Estate Transactions," 37 Taxes 1118 (1959).

Copyrights, literary, musical or artistic compositions

(G) Another special provision is found in sec. 1221(3) of the 1954 Code, with respect to copyrights, or literary, musical or artistic compositions. This was added to the Code in 1950. What is its purpose? [1] Note (as indicated at p. 526(B), above) that it does not prevent the use of the installment basis in determining the tax on the sale of a manuscript.

Suppose that a taxpayer originates and holds a business idea, a trade secret or a trade name. Then he sells it. Does he have capital gain or ordinary income? Does sec. 1221(3) apply? Should any asset which the taxpayer originally acquires at a zero basis be regarded as a capital asset?

There are a number of special provisions allowing capital gains treatment which cut across the definition of "capital assets" in sec. 1221.

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[1] For consideration of these questions, see Fincke, "An Analysis of the Income Aspects of Patents, Copyrights, and Their Analogues," 5 Tax L.Rev. 361 (1950). See also Pilpel, "Developments in Tax Law Affecting Copyrights in 1954," 33 Taxes 271 (1955).

The most important of these is **sec. 1231** of the 1954 Code (which carries forward a provision which was found in sec. 117(j) of the 1939 Code, first enacted in 1942). This section of the Code should be carefully read and digested. Its effect is to allow taxpayers to deduct business losses in full, while gains on sales of business assets (other than inventories) receive the benefit of capital gains treatment. See "Section 117(j): The Taxpayer's Friend," 39 Calif.L.Rev. 528 (1951); Smith, "Problems in the Disposal of Rental Personalty," 13 Tax L.Rev. 331 (1958).

Sec. 1231 contains three special provisions, which made their first appearance in 1951. These are:

Timber and coal. Sales of timber and coal (including coal royalties) may be treated as capital gain transactions to the extent provided by secs. 1231(b)(2) and 631. Note the special provision in sec. 632 limiting the rate of tax on sales of discovered oil and gas properties, even though they may be held for sale to customers. See Bohannon, "The Treatment of Gains and Losses in Timber and Coal Transactions," 27 Geo.Wash.L.Rev. 37 (1958); Tredup, "Confusion under Timber Provisions of Sections 631 and 1231," 35 Taxes 343 (1957).

Livestock. Where livestock is held for draft, breeding or dairy purposes, and has been held for twelve months or more from the date of acquisition, gain on the sale is entitled to capital gain treatment. See Lowrimore, "Tax Savings and Capital Increase in Livestock Raising," 31 Taxes 64 (1953); Halstead, "Capital Gains Treatment on Livestock Sales," 30 Taxes 885 (1952); Jones, "Livestock Sales and Capital Gains Treatment," 7 Tax L.Rev. 510 (1952). See also "Capital Gains Treatment of Cattle Sales: A Proposed Revision," 34 Texas L.Rev. 290 (1955).

Unharvested crop. Where land used in the trade or business is sold with an unharvested crop, the amount paid for the crop is treated as a payment for property to which the provisions of sec. 1231 apply. See Halstead, "Sales of Land with Growing Crops—Tax Treatment," 31 Taxes 55 (1953). In a case arising in a year before this provision became applicable, the Supreme Court held that the amount of the consideration paid which was applicable to the growing crop was taxable as ordinary income. *Watson v. Commissioner,* 345 U.S. 544 (1953).

Note the provisions of sec. 268 of the 1954 Code, disallowing as a deduction the expenses of raising the crop in cases where the crop is sold at a capital gain under sec. 1231.

Other special provisions include the following:

Sale or exchange of patents. Under sec. 1235 of the 1954 Code gain received by a person who develops an invention is taxable

as a capital gain, even though he is a "professional" inventor, that is, he is in the business of making and selling inventions.[1]

Real property subdivided for sale. Sec. 1237 of the 1954 Code contains a new provision under which a person holding real property may subdivide it for sale without having the receipts become taxable as ordinary income. Section 1237 of the 1954 Code was extended to corporations by the Act of April 27, 1957. For general discussion, see Weithorn, "Subdivisions of Real Estate—'Dealer' v. 'Investor' Problem," 11 Tax L.Rev. 157 (1956). See also Levin, "Capital Gains or Income on Real Estate Sales," 37 B.U.L.Rev. 165 (1957).

Taxability of certain termination payments. Sec. 1240 contains a rather strange provision, supposed to be applicable to only a single individual, allowing capital gains treatment to the amount received on the assignment of certain termination payments. Perhaps this is one about which the least said, the better.

Cancellation of lease or distributor's agreement. Reference has already been made (at page 579(D), above) to sec. 1241, relating to cancellation of a lease or distributor's agreement. Under this, amounts received by a lessee (not by the lessor) for the cancellation of a lease, or by a distributor (not by his supplier) for the cancellation of his distributor's agreement, if he has a substantial capital investment, are treated as received in a capital transaction.[2]

Withdrawal from pension plans. The Code contains elaborate provisions with respect to pension and profit-sharing plans. Under these, if the plan is "qualified," payments made into the pension or profit-sharing fund by the employer are not taxable to the employee when made. It is further provided that if the employee takes out his "total distribution" within one taxable year, or if it is paid within one taxable year on account of the

1 See Mortenson, "Patent Royalties—Capital Gain or Ordinary Income," 36 Taxes 787 (1958); Chapman and Mason, "Recent Legislative Developments in Capital Gains and Losses," 42 Cornell L.Q. 138, 142–147 (1957); Joseph, "Tax Treatment of Sales and Licenses of Patents," 32 Taxes 803 (1954); Pavitt, "Patents under Code Section 1235," 33 Taxes 265 (1955).

2 See Schlosberg, "Income Tax Consequences of the Assignment or Cancellation of a Leasehold," 10 Tax L.Rev. 157 (1953). Similar results had been reached in the cases, prior to the addition of this provision in the 1954 Code. See Commissioner v. Golonsky, 200 F.2d 72 (C.A.3d, 1952); Commissioner v. McCue Bros. & Drummond, Inc., 210 F.2d 752 (C.A.2d, 1954). But cf. Commissioner v. Starr Bros., Inc., 204 F.2d 673 (C.A.2d, 1953); Rev.Rul. 129, 1953–2 Cum.Bull. 97.

employee's death or other separation from the service, then the amount distributed to him (or his estate) "shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months." See 402(a)(2) of the 1954 Code. See also sec. 403(a)(2). In this way, very large amounts of compensation may be accumulated for employees, and the amounts so accumulated, together with the income earned on these amounts, may be taken at capital gains rates if the entire amount is withdrawn in the year the employee terminates his services. Whether this is a "pension plan" may be a question.

See Eckerman, "The Unrationalized Capital Gains Treatment of Lump Sum Termination Distributions from Qualified Pension, Profit-Sharing and Annuity Plans," 7 Syracuse L.Rev. 1 (1955).

This list is not exhaustive. There are numerous other provisions in the Code which allow capital gains treatment on certain types of transactions. Often the signal is that the statute says that an amount received "shall be regarded as received on the sale or exchange" of property. See, for example, sec. 331 of the 1954 Code (corporate liquidation payments).

Problem

Are these extensions of capital gains provisions justifiable?[2] Is there any reason to suppose that they may have been influenced by pressures of some sort? Is it desirable that all income should be taxable at capital gain rates? Is there anything in these developments which might be regarded as discriminatory by the recipients of wages and salaries, or dividends and interest, or other types of income which are taxable at high normal and surtax rates?

There is at least one provision which works the other way. This is found in sec. 1239 of the 1954 Code. Under this, gain from the sale of depreciable property between a husband and wife, or between an individual and a controlled corporation, is taxable as ordinary income.

Problem

What is the purpose of this provision? Why is it necessary—or desirable?

Suppose that the sale is by one corporation to another, both being controlled by the same individual. Is this provision applicable? Should it be? Suppose that the sale is by a parent corporation to a subsidiary corporation. Is the provision applicable? Should it be? Is there a serious loophole in the latter case,

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[2] See Miller, "Capital Gains Taxation of the Fruits of Personal Effort: Before and under the 1954 Code," 64 Yale L.J. 1 (1954).

one which might enable a corporation having fully depreciated property to transfer it to a wholly owned subsidiary, at capital gains rates, with the result that the subsidiary would have a substantial basis on which depreciation deductions would be allowable at current high income and excess profits rates?

E. WHAT IS A SALE OR EXCHANGE?

See Sec. 1222 of the 1954 Code

Under the various provisions of sec. 1222 (formerly found in sec. 117 of the 1939 Code), the several types of capital gain and loss all arise on "the sale or exchange of a capital asset." Thus the term "sale or exchange" is central to the concept of capital gain or loss. We have seen some aspects of this question in such cases as the *Arrowsmith* case.

Although the following ruling is now superseded by sec. 1235 of the 1954 Code as far as inventors and some others are concerned, the ruling apparently remains applicable to similar arrangements made by other patent owners. What is the distinction between a "sale" and a "royalty agreement"?

MIM. 6490

Bureau of Internal Revenue, 1950. 1950–1 Cum.Bull. 9.

1. The Tax Court of the United States held in *Edward C. Myers v. Commissioner* (6 T.C. 258) that under the terms of the exclusive license agreement between the petitioner and the B. F. Goodrich Rubber Company the petitioner sold his invention to Goodrich. The Commissioner's acquiescence in the *Myers* decision was published in Internal Revenue Bulletin No. 12 dated June 17, 1946.

2. Further consideration has been given to the question as to whether the decision in the *Myers* case should be accepted as a precedent in the determination of income tax liabilities of other taxpayers with respect to contracts containing essentially the same provisions.

3. The exclusive license agreement considered in the *Myers* case provided, among other things, that the licensor is to receive from the licensee in return for the exclusive right to manufacture, use, and sell the patented article annual payments equal to 5% of the selling price of the articles manufactured and sold, such annual payments, however, not to be less than a specified minimum annual amount.

4. The Bureau has reached the conclusion that where the owner of a patent enters into an agreement whereby, in consideration of the assignment of the patent, or the license of the exclu-

sive right to make, use, and sell a patented article, the assignee or licensee agrees to pay to the assignor or licensor an amount measured by a fixed percentage of the selling price of the article so manufactured and sold or amounts per unit based upon units manufactured or sold, or any other method measured by production, sale or use either by assignee or licensee, or amounts payable periodically over a period generally coterminous with the transferee's use of the patent, such agreement, for income tax purposes, are to be regarded as providing for the payment of royalties taxable as ordinary income.

5. Acquiescence in the decision of the Tax Court of the United States in *Edward C. Myers v. Commissioner* (6 T.C. 258), as it relates to the issue whether the payments involved therein were taxable as gain from the sale of property, is hereby withdrawn and nonacquiescence substituted.

6. It is held, under authority contained in Section 3791(b) of the Internal Revenue Code, that this ruling shall not be applied with respect to royalties received from such exclusive license agreements for taxable years beginning prior to June 1, 1950.

7. Inquiries regarding this Mimeograph should refer to the number thereof and the symbols IT:EIM.[1]

Notes

(A) See, generally, "Elements of a Section 117 'Sale or Exchange,'" 53 Col.L.Rev. 976 (1953).

Retirement of Bonds

(B) When a bond is paid at maturity (perhaps at a gain to the holder), is this a "sale or exchange"? In cases arising before there were any special statutory provisions, it was held that payment was not a "sale or exchange."[2] This is now covered by sec. 1232(a)(1) of the 1954 Code, under which amounts received on the retirement of the obligations there specified "shall be considered as amounts received in exchange therefor." See also secs. 1.1232–1 through 1.1232–4 of the Income Tax Regulations.

Note that this does not apply to all debt obligations. It is not applicable at all to obligations undertaken by individuals. And in the case of corporate and governmental obligations issued before January 1, 1955, it applies only if they were issued with interest coupons or in registered form, or were in such form on

[1] Compare Commissioner v. Wodehouse, 337 U.S. 369 (1949), and comments on that case in 48 Mich.L.Rev. 132 (1949), and 23 So.Calif.L.Rev. 154 (1949). In the Wodehouse case amounts received in a lump sum by a non-resident alien for exclusive serial or book rights throughout the United States were held not received on a sale, and were taxable under a statute imposing the tax on non-resident aliens on "fixed or determinable annual or periodical income."

[2] *Cf.* White v. United States, 305 U.S. 281 (1938); Helvering v. Chester N. Weaver Co., 305 U.S. 293 (1938); and Fairbanks v. United States, 306 U.S. 436 (1939).

March 1, 1954.[3] Thus, for many years the form of instruments issued before January 1, 1955, will be relevant in the application of this provision.

Section 1232 contains other provisions relating to the sale or exchange of obligations issued at a discount, and of obligations purchased with unmatured coupons detached. These should be carefully examined. Why are they necessary? [4]

See Greenberg, "Discount Obligations—Capital Gain or Ordinary Income," 10 Miami L.Q. 18 (1955); Chapman and Mason, "Recent Legislative Developments in Capital Gains and Losses," 42 Cornell L.Q. 138, 148–152 (1957).

Retirement of Stock

(C) Suppose a corporation makes a distribution in partial or total liquidation, thus retiring some or all of its own stock. This is somewhat analogous to the retirement of bonds. Does it involve a "sale or exchange"? The matter is covered by **sec. 331** of the 1954 Code, under which amounts so paid are treated as "in exchange for the stock."

Purchase and Sale by a Corporation of Its Own Stock

(D) It seems obvious that a corporation does not have income when it originally issues its own stock. That is a capital transaction. Thereafter, however, the corporation may reacquire some of its stock. Such stock may then be retired. Or it may be held as treasury stock. In the latter event it might be reissued, perhaps at a price higher than that for which it was bought in. Or it may deal in its own stock substantially as it would in any other commodity. Does the corporation have income in such situations? Early regulations provided that no gain or loss should be derived by a corporation on issuing or reacquiring its own stock. Under this regulation, it was held that there was no income to a corporation on sales of its own stock, no matter how acquired. *Helvering v. R. J. Reynolds Tobacco Co.,* 306 U.S. 110 (1939).

By 1934, the regulation was changed to provide that a corporation would have income if, in substance, it "dealt" in its own stock, as a commodity. This regulation was upheld.[5] See also *United States v. Anderson, Clayton & Co.,* 350 U.S. 55 (1955).

In the 1954 Code, it is provided (**sec. 1032**) that a corporation will not derive gain or loss on the receipt of money or other property for its own stock. Although the language of the section is perhaps a little cryptic, the committee reports make it clear that this provision is designed to upset the rule which has been pro-

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[3] Cf. Lurie v. Commissioner, 156 F.2d 436 (C.C.A.9th, 1946).

[4] See also Warner A. Shattuck, 25 T.C. 416 (1955) where bonds were purchased with overdue interest outstanding, and were then sold back to the issuing corporation. It was held that this was interest and not capital gain.

Note that the provisions in sec. 1232(a)(2) are applicable only to bonds issued after December 31, 1954.

[5] Allen v. Nat. Manufacture & Stores Corp., 125 F.2d 239 (C.C.A.5th, 1942); Helvering v. Edison Bros. Stores, 133 F.2d 575 (C.C.A.2d, 1943). For consideration of the question, see Rankin, "Income Tax Aspects of a Corporation's Dealings in Its Own Shares," 89 U. of Pa.L.Rev. 934 (1941); Musselman, "On the Nature of the Gain on Treasury Stock," 70 J. of Accountancy 104 (1940).

vided by the regulations for the past twenty years. See also sec. 1.1032–1 of the Income Tax Regulations.

Is the new statutory provision a desirable one? Are there any abuses which may become possible under it?

Stocks and Bonds Becoming Worthless

(E) Instead of being redeemed or paid off, stocks and bonds may become worthless. In such a case there is no "transaction." There is nothing that may be regarded as a sale or exchange. The owner still has the stocks or bonds; they simply have no value any more. Sec. 165(a) and (c)(2) of the 1954 Code allows the deduction of the loss in such a case. But is it a capital loss or an ordinary loss? If it is the latter it may be deductible in full; if it is a capital loss, the effective deduction may be sharply limited.

This is covered by sec. 165(g) of the 1954 Code, under which such losses are capital losses. See also secs. 1.165–1 through 1.165–10 of the Income Tax Regulations.

Special treatment is provided for loss on worthlessness or sale of certain stock of a "small business corporation" under sec. 1224, added by the Small Business Tax Revision Act of 1958. See Groh, "What to Do about Stock of the Small Business Corporation," 37 Taxes 225 (1959).

Loss by Fire or Government Seizure

(F) The taxpayer's building was destroyed by fire, and it received $73,000 as insurance. The building had been fully depreciated prior to the taxable year. The taxpayer returned the insurance money as capital gain, using it to offset a capital loss. The Court held that the insurance money was not acquired on a sale or exchange of the property and was taxable as ordinary income. *Helvering v. William Flaccus Oak Leather Co.,* 313 U.S. 247 (1941).

Or suppose the property is seized by the government under its power of eminent domain. The taxpayer receives a payment which is higher than his basis for the property. Is this a "sale"? Is the gain a capital gain?

These questions are now covered by **sec. 1231** of the 1954 Code, under which aggregate gains are treated as capital gains, while aggregate losses are treated as ordinary losses.

(G) In 1944–45, the Government seized all of the property of a number of motor carriers, and operated the properties. They were turned back late in 1945. Claims were filed with the Government for just compensation and these were paid in 1952. Was the amount received taxable as ordinary income, or was this an involuntary conversion with the proceeds taxable as a capital gain under what is now sec. 1231 of the Code? See *Commissioner v. Gillette Motor Transport, Inc.,* —— U.S. —— (1960).

Involuntary or Compulsory Sales

(H) The taxpayer bought land for profit, giving a mortgage for part of the purchase price. He was unable to meet the mortgage payments. The mortgage was foreclosed through a judicial sale at which the mortgagee was the purchaser. The Court held

that the mortgagor's loss resulted from a sale or exchange, and was subject to the limitations on capital losses. *Helvering v. Hammel,* 311 U.S. 504 (1941). The same result has been reached although the taxpayer acquired the property subject to the mortgage, and was not liable on it. *Welch v. Street,* 116 F.2d 953 (C.C.A.1st, 1941). Similarly, the loss is a capital loss when the mortgagor surrenders the property to the mortgagee for the release of his personal liability. *Rogers v. Commissioner,* 103 F.2d 790 (C.C.A.9th, 1939). Suppose the taxpayer simply abandons the property. Suppose the taxpayer surrenders the property and in addition makes a cash payment to secure a release of personal liability. Is the additional payment a capital loss or an ordinary loss? See *Commissioner v. Paulson,* 123 F.2d 255 (C.C.A.8th, 1941).[6]

(I) T and five others owned undivided interests in real property as tenants in common. T desired to purchase the interest of one of the tenants but no price could be agreed on. T then filed a partition action, forcing a sale of the property. T and the other four co-owners bought in the property at the partition sale. The Treasury ruled that this was a non-taxable transaction as far as T and his four co-owners were concerned. T did not actually sell anything. The effect of the sale was to establish the price at which the interest of the fifth co-owner could be bought. Rev.Rul. 55–77, 1955–1 Cum.Bull. 339.

STARR v. COMMISSIONER

United States Court of Appeals, Ninth Circuit, 1959. 274 F.2d 294.

CHAMBERS, CIRCUIT JUDGE. Yesterday's equities in personal property seem to have become today's leases. This has been generated not a little by the circumstance that one who leases as a lessee usually has less trouble with the federal tax collector. At least taxpayers think so.

But the lease still can go too far and get one into tax trouble. While according to state law the instrument will probably be taken (with the consequent legal incidents) by the name the parties give it, the internal revenue service is not always bound and can often recast it according to what the service may consider the practical realities.[1] We have so held in *Oesterreich v. Commissioner,* 9 Cir., 226 F.2d 798, and *Commissioner of Internal Revenue v. Wilshire Holding Corporation,* 9 Cir., 244 F.2d 904, certiorari denied 355 U.S. 815. The principal case concerns a fire sprinkler system installed at the taxpayer's plant at Monrovia, California, where Delano T. Starr, now deceased, did business as

[6] The problems are discussed in Smith, "Mortgagor's Losses—Are They Capital or Ordinary?" 18 Taxes 546 (1940); Paul, "Federal Income Tax Problems of Mortgagors and Mortgagees," 48 Yale L.J. 1315 (1939), also in Selected Studies in Federal Taxation, Third Series 296 (1940); Heineman, "Income Tax Problems in Mortgage Foreclosures," 32 Ill.L.Rev. 189 (1937).

[1] Thus it shifts rental payments of a business (fully deductible) to a capital purchase for the business. If the nature of the property is wasting, then depreciation may be taken, but usually not all in one year.

the Gross Manufacturing Company. The "lessor" was "Automatic" Sprinklers of the Pacific, Inc., a California corporation. The instrument entitled "Lease Form of Contract" (hereafter "contract") is just about perfectly couched in terms of a lease for five years with annual rentals of $1,240. But it is the last paragraph thereof, providing for nominal rental for five years, that has caused the trouble. It reads as follows:

> "28. At the termination of the period of this lease, if Lessee has faithfully performed all of the terms and conditions required of it under this lease, it shall have the privilege of renewing this lease for an additional period of five years at a rental of $32.00 per year. If Lessee does not elect to renew this lease, then the Lessor is hereby granted the period of six months in which to remove the system from the premises of the Lessee."

Obviously, one renewal for a period of five years is provided at $32.00 per year, if Starr so desired. Note, though, that the paragraph is silent as to status of the system beginning with the eleventh year. Likewise the whole contract is similarly silent.

The tax court sustained the commissioner of internal revenue, holding that the five payments of $1,240, or the total of $6,200, were capital expenditures and not pure deductible rental.[3] Depreciation of $269.60 was allowed for each year. Generally, we agree.

Taxpayers took the deduction as a rental expense under trade or business pursuant to Section 23(a) of the Internal Revenue Code, as amended by Section 121(a) of the Revenue Act of 1942.[4]

The law in this field for this circuit is established in *Oesterreich v. Commissioner, supra,* and *Robinson v. Elliot,* 9 Cir., 262 F.2d 383. There we held that for tax purposes form can be disregarded for substance and, where the foreordained practical effect of the rent is to produce title eventually, the rental agreement can be treated as a sale.

In this, Starr's case, we do have the troublesome circumstance that the contract does not by its terms ever pass title to the system to the "lessee." Most sprinkler systems have to be tailor-made for a specific piece of property and, if removal is required,

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[3] Starr, Estate of, v. Commissioner, 30 T.C. 856.

[4] "§ 23 Deductions from gross income

"In computing net income there shall be allowed as deductions:

"(a) *Expenses.*—

"(1) *Trade or business expenses.*

"(A) *In General.* All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. * * *" 26 U.S.C.A. § 23.

the salvagable value is negligible. Also, it stretches credulity to believe that the "lessor" ever intended to or would "come after" the system. And the "lessee" would be an exceedingly careless businessman who would enter into such contract with the practical possibility that the "lessor" would reclaim the installation. He could have believed only that he was getting the system for the rental money. And we think the commissioner was entitled to take into consideration the practical effect rather than the legal, especially when there was a record that on other such installations the "lessor", after the term of the lease was over, had not reclaimed from those who had met their agreed payments. It is obvious that the nominal rental payments after five years of $32.00 per year were just a service charge for inspection.[5]

Recently the Court of Appeals for the Eighth Circuit has decided *Western Contracting Corporation v. Commissioner,* 1959, 271 F.2d 694, reversing the Tax Court in its determination that the commissioner could convert leases of contractor's equipment into installment purchases of heavy equipment. The taxpayer believes that case strongly supports him here. We think not.[6]

There are a number of facts there which make a difference. For example, in the contracts of Western there is no evidence that the payments on the substituted basis of rent would produce for the "lessor" the equivalent of his normal sales price plus interest. There was no right to acquire for a nominal amount at the end of the term as in Oesterreich and the value to the "lessor" in the personalty had not been exhausted as in Starr's case. And there was no basis for inferring that Western would just keep the equipment for what it had paid. It appears that Western paid substantial amounts to acquire the equipment at the end of the term. There was just one compelling circumstance against Western in its case: What it had paid as "rent" was apparently always taken into full account in computing the end purchase price. But on the other hand, there was almost a certainty that the "lessor" would come after his property if the purchase was not eventually made for a substantial amount. This was not even much of a possibility in Oesterreich and not a probability in Starr's case.

In *Wilshire Holding Corporation v. Commissioner,* 9 Cir., 262 F.2d 51, we referred the case back to the tax court to consider interest as a deductible item for the lessee. We think it is clearly

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[5] It is true that the normal inspection fee would be $64.00. However, the difference between $32.00 and $64.00 would not seem to ruin the tax court's determination for income tax purposes that there was a sale.

[6] It is unnecessary to determine here whether the Ninth Circuit would follow the decision of the Eighth Circuit or the decision of the tax court. (Western Contracting Corp. v. Commissioner, 17 TCM 371, T.C.Memo. 1958–77, CCH. Dec. 22, 960[M]). It is enough here to say that the Ninth Circuit regards the Eighth Circuit's opinion distinguishable from Starr's case and not inconsistent with the holding herein.

called for here. Two yardsticks are present. The first is found in that the normal selling price of the system was $4,960 while the total rental payments for five years were $6,200. The difference could be regarded as interest for the five years on an amortized basis. The second measure is in clause 16 (loss by fire), where the figure of six per cent per annum discount is used. An allowance might be made on either basis, division of the difference (for the five years) between "rental payments" and "normal purchase price" of $1,240, or six per cent per annum on the normal purchase price of $4,960, converting the annual payments into amortization. We do not believe that the "lessee" should suffer the pains of a loss for what really was paid for the use of another's money, even though for tax purposes his lease collapses.

We do not criticize the commissioner. It is his duty to collect the revenue and it is a tough one. If he resolves all questions in favor of the taxpayers, we soon would have little revenue. However, we do suggest that after he has made allowance for depreciation, which he concedes, and an allowance for interest, the attack on many of the "leases" may not be worth while in terms of revenue.

Decision reversed for proceedings consistent herewith.

Notes

(A) For other cases on this question, see *Benton v. Commissioner,* 197 F.2d 745 (C.A.5th, 1952); *Rotorite Corp. v. Commissioner,* 117 F.2d 245 (C.C.A.7th, 1941); *Commissioner v. Celanese Corp.,* 140 F.2d 339 (App.D.C.1944); *Breece Veneer and Panel Co. v. Commissioner,* 232 F.2d 319 (C.A.7th, 1956).[1]

(B) In *Haggard v. Commissioner,* 241 F.2d 288 (C.A.9th, 1956), the arrangement with respect to land provided for a rental payment of $10,000 a year for two years. There was an option to buy the land then for $24,000. The court held that this was a sale, and that the "rental" payments were not deductible.

The general problem is discussed at some length by the Treasury in Rev.Rul. 55–540, 1955–2 Cum.Bull. 39. See also Rev.Rul. 60–122, 1960–1 Cum.Bull. ——.

(C) A bank bought automotive equipment and leased it to the taxpayer, which agreed to pay a stipulated rent. The rent was

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[1] See also Lutkins, "Tax Treatment of the Lease with Option to Purchase: Is Allocation the Answer?" 11 Tax L.Rev. 65 (1956); Kirby, "Considerations in Business Lease Arrangements," 34 Taxes 34 (1956); "Acquisition of Industrial and Commercial Equipment Through Leasing Arrangements," 66 Yale L.J. 751 (1957); Grayck, "Taxing Income that Is Applied against the Purchase Price," 12 Tax L.Rev. 381 (1957); Griesinger, Pros and Cons of Leasing Equipment," 33 Harv.Bus.Rev. 75 (Mar.-Apr. 1955); Newlin, "Leasing Industrial Machinery—Some Tax Problems of the Lessee," 33 Taxes 138 (1955); "Tax Treatment of 'Lessors' and 'Lessees' under Lease-Purchase Agreements," 62 Yale L.J. 273 (1953); Sternbach, "Lease Agreements Containing Options to Buy," 26 Taxes 741 (1948).

fixed at an amount designed to cover the cost of the vehicles and interest over an agreed period. The taxpayer had all rights except title and all obligations with respect to the property, and was entitled to any salvage on final disposition. The Treasury ruled that this was a financing arrangement and not a lease. The taxpayer is entitled to deduct depreciation on the vehicles spread over their useful life. The "rent" specified in the agreement should be capitalized except to the extent that it covers interest. Rev.Rul. 55–25, 1955–1 Cum.Bull. 283.

F. IDENTIFICATION OF PROPERTY SOLD, AND APPLICATION OF CONSIDERATION

In *Helvering v. Rankin,* 295 U.S. 123 (1935), the taxpayer had a margin account with a broker, the stock in which was the product of a number of purchases and sales. No stock certificates were issued to him. In connection with the sales, the taxpayer told the broker to sell the stock most recently purchased. The Court held that this was a sufficient identification, and that the taxpayer's gain was to be determined by using as a basis the cost of the stock most recently purchased. In *Davidson v. Commissioner,* 305 U.S. 44 (1938), it appeared that the taxpayer instructed his broker to sell the shares purchased on a certain date, and directed his bank to deliver the certificates for those shares to the broker. By mistake, the bank sent the broker another certificate purchased by the taxpayer at a different time and price. The Court held that the certificate actually delivered was determinative, saying (p. 46): "The commissioner rightly computed gain on the basis of what was done rather than on what petitioner intended to do."

In the absence of an identification, the regulations provide that gains or losses shall be determined on a first in, first out basis. Sec. 1.1012–1(c) of the Income Tax Regulations. But where securities are bought at various dates at different prices, and later are merged into a single security, through reorganization, or otherwise, gain or loss may be determined on an average cost bases. See *Arrott v. Commissioner,* 136 F.2d 449 (C.C.A.3d, 1943), and note in 149 A.L.R. 988 (1944). But see *Bloch v. Commissioner,* 148 F.2d 452 (C.C.A.9th, 1945), where the taxpayer was successful in contending that he could identify the securities sold in such a case.

REVENUE RULING 56–653

Internal Revenue Service, 1956. 1956–2 Cum.Bull. 185.

Advice is requested as to the identification of shares sold where, in a preceding stock split, the stockholder retained his original certificates and received only one new certificate for all the additional stock distributed to him.

A owned three separately acquired lots of stock in a corporation for which he had three certificates, as follows:

Date acquired	Date of certificate	No. of certificate	No. of shares
Jan. 3, 1955	Jan. 6, 1955	10001	25
Feb. 8, 1955	Feb. 11, 1955	11003	50
Nov. 21, 1955	Nov. 25, 1955	21006	100

On January 4, 1956, at a special meeting of the stockholders, the corporation's charter was amended to provide for a three-for-one stock split. The stockholders retained their old, originally acquired, certificates, and these certificates still represented the same number of shares as before the split. In addition, each stockholder received a single new certificate for all the additional shares to which he was entitled. Accordingly, *A* retained his three old certificates for a total of 175 shares, and received a single new certificate for 350 shares, representing his additional shares in all three lots. After the stock split, the lot of stock acquired January 3, 1955, consisted of 75 identical shares, of which 25 were evidenced by the old certificate and 50 were evidenced by the new certificate; similarly, the lot of stock acquired February 8, 1955, consisted of 150 shares, 50 evidenced by the old certificate and 100 by the new certificate; and the lot acquired November 21, 1955, consisted of 300 shares, 100 evidenced by the old certificate and 200 by the new certificate.

Section 307 of the Internal Revenue Code of 1954 provides in part as follows:

"(a) General Rule. If a shareholder in a corporation receives its stock or rights to acquire its stock (referred to in this subsection as 'new stock') in a distribution to which section 305(a) applies, then the basis of such new stock and of the stock with respect to which it is distributed (referred to in this section as 'old stock'), respectively, shall, in the shareholder's hand, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock. Such allocation shall be made under regulations prescribed by the Secretary or his delegate."

In the instant case, the total basis of all the shares in each separate lot is the same after the split as it was before. However, since, as a result of the split, there were three times as many identical shares, the basis per share in each lot became one-third of the former basis per share in such lot.

On October 18, 1956, *A* sold 40 shares of his stock in the corporation and desired to identify these shares as being out of the lot acquired February 8, 1955. At the time of the sale, this

lot consisted of 150 identical shares, 50 evidenced by the old certificate and 100 by the new certificate. Immediately after the execution of the sale, *A* sent his old certificate for the lot acquired February 8, 1955, as well as the certificate for 350 shares received at the time of the split, to the corporation, and requested it to issue the following new certificates to him (after issuing a certificate for 40 shares to the buyer):

(1) a new certificate for 110 shares to cover the 50 shares which originally constituted the lot acquired February 8, 1955, plus the 100 shares issued in the stock split with respect to this lot, minus the 40 shares sold out of this lot;

(2) a new certificate for the 50 shares of stock issued in the stock split allocable to the 25 shares which originally constituted the lot acquired January 3, 1955;

(3) a new certificate for the 200 shares issued in the stock split allocable to the 100 shares which originally constituted the lot acquired November 1, 1955.

A kept appropriate records showing the time and terms of each stock acquisition made by him, the number and date of each certificate received by him, the time and terms of each sale, and the particular lot out of which each sale was made. These records noted the facts showing that the 110 shares covered by certificate (1) above resulted from the acquisition described, the subsequent stock split, and the sale, and similarly noted the facts showing to which lot the shares evidenced by certificates (2) and (3) were allocable.

Upon all the facts recited, it is held that *A* has adequately identified the 40 shares being sold, and that, therefore, the basis of such 40 shares is the basis, before the split, for the 50 shares acquired on February 8, 1955, divided by 150 (the number of shares into which the lot was split), and multiplied by 40 (the number of shares sold). As to the shares within any one lot, no distinction may be made between the shares evidenced by the old certificate and those evidenced by the new certificate, since all such shares are identical.

HAMLIN'S TRUST v. COMMISSIONER

Court of Appeals, Tenth Circuit, 1954. 209 F.2d 761.

BRATTON, CIRCUIT JUDGE. These are petitions to review decisions of the Tax Court. In their tax returns for the year 1946, the trustees of the Clarence Clark Hamlin Trust, and T. E. Nowels and wife Bertie M. Nowels, treated all of the revenue which they received from R. C. Hoiles and his associates as revenue derived from the sale of capital assets. The Commissioner of Internal Revenue disagreed with that treatment of such revenue and re-

sulting deficiencies were imposed. On redetermination, the Tax Court found and determined among other things that of each $200 received from Hoiles and his associates $150 was in payment for capital stock and was taxable as revenue derived from the sale of capital assets while the remaining $50 represented consideration for a covenant not to engage in business in competition with Hoiles and was taxable as ordinary income. And having made that finding, the court sustained the action of the Commissioner, 19 T.C. 718. The trustees of the Hamlin Trust, the executors of the estate of T. E. Nowels, then deceased, and Bertie M. Nowels, seasonably brought the proceedings here on petitions to review.

The evidence as a whole disclosed these facts. Gazette and Telegraph Company, a corporation, owned a plant and published a newspaper in Colorado Springs, Colorado. The corporation had issued and outstanding 5,000 shares of capital stock, each of the par value of $100. The names of the stockholders and the number of shares owned by them respectively were, El Pomar Investment Company 1248, Clarence Clark Hamlin Trust 1146, T. E. Nowels 950, Charles L. Tutt 703, John A. Carruthers 254, Marguerite Ross 156, Grace C. Foster and Helen Francis Foster 104, Richard W. Nowels 100, Frank R. Wadell 100, Seddie G. Hamlin 100, Mae A. Carruthers 77, James R. Miller 60, and Elizabeth H. Hylbom 2. T. E. Nowels was president of the corporation and editor of the paper. He was an experienced newspaper publisher and was widely known in Colorado Springs. While he was about seventy years of age, he was in good health and had no intention of retiring. Frank R. Wadell was managing editor of the newspaper. Richard W. Nowels, son of T. E. Nowels, was employed on the newspaper. Charles L. Tutt was a man of wealth and had various financial interests, including an interest in El Pomar Investment Company. John A. Carruthers was a lawyer and had various financial interests. Tutt and Carruthers were associated closely together in some of their interests. R. C. Hoiles resided in California, and he was a man of long and varied experience in the newspaper business. Beginning in the fall of 1945, a series of letters passed between Hoiles and Nowels in regard to Hoiles acquiring the newspaper at Colorado Springs. Hoiles offered $750,000 for all of the outstanding stock of the corporation. Nowels rejected the offer and said that he and other stockholders thought their entire setup was worth not less than $1,000,000. After obtaining additional information, Hoiles wrote Nowels offering to pay $1,000,000 for all of the stock of the corporation and an agreement on the part of the stockholders not to enter the newspaper business in that area for the next ten years. Nowels replied that the offer would be given immediate and serious consideration. In the letter he further said that it would be hard for

him to make a decision since he would be selling not only his stock but also his job. Hoiles wrote Nowels in reply that in the event he should buy the property he would be glad to have Nowels remain with the paper for two or three years as counselor and advisor, and that for such service he would be willing to pay Nowels on the basis of five per cent of the profits before taxes. And it was further said in the letter that Hoiles and his associates would want part of the price for the stock to be a restraining contract so that it could be set up in a new corporation on an amortized basis and thus reduce their taxes. As letters were received from Hoiles, Nowels promptly submitted them to Tutt and Carruthers. Similarly, as letters were written to Hoiles, Nowels submitted copies of them to Tutt and Carruthers. Tutt and Carruthers were familiar with developments as they occurred. Hoiles and his two sons came to Colorado Springs to consummate the purchase. Shortly after their arrival, Nowels accepted for one year the offer to remain with the paper in consideration of five per cent of the net profits before taxes, and the agreement was carried out. After Hoiles and his sons arrived in Colorado Springs, Carruthers prepared a proposed written contract in accordance with his understanding of the agreement negotiated by Nowels and Hoiles. In the proposed contract, Hoiles and his two sons were designated as parties of the first part, and the thereto subscribing owners of stock were designated as parties of the second part. The contract provided that the parties of the first part agreed to pay each of the parties of the second part $200 per share for each share set opposite their names respectively of the stock in the corporation. And it further provided in a separate paragraph that the parties of the second part and each of them agreed as part of the consideration thereof that they and each of them would not engage in the newspaper publication or distribution business in competition with the parties of the first part, or their successors and assigns, in the county in which Colorado Springs was situated for a period of ten years from and after the date of the contract. On the day following the draft of the proposed contract, Nowels, his son Richard, Tutt, and Carruthers met with Hoiles and his sons for the purpose of consummating the transaction. At the conference, Hoiles stated that the contract as prepared by Carruthers was satisfactory, but he inquired whether the sellers would have any objection to putting in the contract a provision that the stock be evaluated at $150 per share and the restraining order at $50 per share. He stated in substance that the purpose of the suggested provision was to make such provision for non-competition enforceable and to help him and his associates tax-wise. With very little discussion, the stockholders present agreed to the suggested provision because they thought it would make no difference to them. Thereupon, Hoiles dictated

a new or additional paragraph and it was included in the proposed contract. It provided that the parties agreed that the two items of sale were evaluated (a) the stock at $150 per share, and (b) the prohibition and refraining from carrying on business at $50. As thus amended, the contract was signed by the Hamlin Trust, Nowels, Tutt, Carruthers, and other owners of stock. All of the stock was transferred; the $1,000,000 was paid; and the transaction was completed. . . .

The finding of the Tax Court that of each $200 which Hoiles and his associates paid to the taxpayers and other stockholders of the publishing company, $150 was for stock and $50 was for the covenant not to enter the newspaper business is attacked on the ground that it is not supported by evidence. It is argued in support of the contention that the basic transaction never involved any agreement in respect to the relative value of the stock and the covenant; that in reality the entire sum was paid for stock and a covenant without any separate statement of value for the covenant; that the only reason for the separate statement of value was to reduce the taxes of Hoiles and his associates; and that therefore the entire sum received from Hoiles was subject to tax as revenue derived from the sale of capital assets. It is well settled that the incidence of taxation depends upon the substance of a transaction; that tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title; and that the Government may look at the realities of a transaction and determine its tax consequences despite the form or fiction with which it was clothed. *Higgins v. Smith,* 308 U.S. 473; *Commissioner of Internal Revenue v. Court Holding Co.,* 324 U.S. 331; *Jones v. Grinnell,* 10 Cir., 179 F.2d 873.

Hoiles made it clear in the correspondence with Nowels that in the event he and his associates should purchase the stock they would want a covenant on the part of the stockholders not to enter the newspaper business in the Colorado Springs area. At the conference convened for the purpose of consummating the transaction, the parties present agreed verbally that the money paid should be allocated to the sale and purchase of stock and an agreement not to re-enter the newspaper business, the basis of the allocation being $150 for each share of stock and $50 for the covenant. After reaching that verbal agreement, the written contract was revised accordingly. And the added provision inserted in the contract was free from doubt or ambiguity. Nowels was a party to the verbal agreement, and he signed the written contract; and the written contract was signed by the Hamlin Trust and other owners of stock. It is true that there was very little discussion of the suggested allocation. But the effectiveness taxwise of an agreement is not measured by the amount of pre-

liminary discussion had respecting it. It is enough if parties understand the contract and understandingly enter into it. The proposed change in the contract was clear. All parties participating in the conference agreed to it. The owners of stock present signed the written contract at the time and others signed it later. It is reasonably clear that the sellers failed to give consideration to the tax consequences of the provision, but where parties enter into an agreement with a clear understanding of its substance and content, they cannot be heard to say later that they overlooked possible tax consequences. While acting at arm's length and understandingly, the taxpayers agreed without condition or qualification that the money received should be on the basis of $150 per share for the stock and $50 per share for the agreement not to compete. Having thus agreed, the taxpayers are not at liberty to say that such was not the substance and reality of the transaction. Cf. *Clover v. Commissioner,* 9 Cir., 143 F.2d 570; *Titus v. United States,* 10 Cir., 150 F.2d 508, 162 A.L.R. 991, certiorari denied, 326 U.S. 773.

Where a covenant not to compete constitutes a nonseverable element of a transaction in which the owner of a going concern sells the property and transfers the good will of the business, the covenant is to be treated as a contributing element of the assets transferred and the entire revenue received is subject to tax on the basis of a capital gain. *Toledo Newspaper Co.,* 2 T.C. 794; *Michaels,* 12 T.C. 17. But if a covenant not to compete can be segregated in order to be assured that a separate item has actually been dealt with, then so much as is received for the covenant is ordinary income rather than income from the sale of a capital asset. *Estate of Mildred K. Hyde,* 42 B.T.A. 738; *Horton,* 13 T.C. 143.

In the transaction under consideration no title to the property or assets of a going concern passed from one ownership to another. These taxpayers and other owners of stock in the corporation did not sell the property, assets, or good will of a going concern. They merely sold stock. The contract for the sale of the stock contained a severable provision in which the sellers of stock covenanted not to engage in the newspaper business in a specified area. And it contained separate and distinct provision evaluating the stock and the covenant not to compete, the evaluation being computed on the basis of $150 per share for the stock and $50 per share for the covenant. Thus it is clear that the covenant not to compete was severable; that the parties dealt with it separately; and that the amount received for it was specified and therefore is ascertainable. The amount which the taxpayers received as consideration for the covenant is subject to tax as ordinary income, not income from the sale of capital assets. *Cox v. Helvering,* 63 App.D.C. 264, 71 F.2d 987; *Salvage v. Commission-*

er, 2 Cir., 76 F.2d 112, affirmed, *Helvering v. Salvage,* 297 U.S. 106; *Beals' Estate v. Commissioner,* 2 Cir., 82 F.2d 268.

The decisions of the Tax Court are severally affirmed.

Notes

(A) But the allocation of the consideration made by the parties will not be binding on the government. In *Particelli v. Commissioner,* 212 F.2d 498 (C.A.9th, 1954), the taxpayer owned a winery. A buyer wanted to buy a large amount of wine, but because of the then existing O. P. A. regulations an adequate profit could not be made on the sale. The taxpayer then offered to sell his entire property, the winery with the wine, for $350,000. The buyer had no particular interest in the winery, but the purchase was a means of getting the wine he wanted. He accepted the offer. A contract of sale was entered into which specified that the sale price of the wine was $77,000, and the balance or $273,000, was for the winery. The taxpayer included the $77,000 as ordinary income, and returned a capital gain on the winery in the amount of $217,634 (his basis for the winery having been $55,366).

The Commissioner determined a deficiency by allocating $302,500 as the purchase price of the wine, and $47,500 for the winery. The Tax Court concluded that a proper allocation was $275,000 for the wine and $75,000 for the winery. This was sustained by the Court of Appeals.

(B) The taxpayer owned a tract of land containing 915 acres. He attempted to sell it, but was unsuccessful because the tract did not include all the shore line of a lake. Purchasers would not buy unless they could be assured complete control of the lake. The taxpayer then negotiated for the adjoining 20 acres which were needed to complete the shore line ownership. After long effort, he was finally able to buy the 20 acres for $9,115. The fair market value of this 20 acres was $1,500. He immediately sold the two tracts together for a single consideration of $70,050. This was the fair market value of the entire area. It was held that he could properly allocate $1,500 of the aggregate consideration received as the amount paid for the 20 acres, and that he had a short term loss of $7,615 on the smaller tract. *Harlow N. Davock,* 20 T.C. 1075 (1953).[1]

G. AMOUNT REALIZED

Sec. 1001(6) of the 1954 Code

Section 1.453–6(a)(1) of the Income Tax Regulations provides that where property is sold with payment to be made later, "the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction."

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[1] See Holzman, "Tie-in Purchases—Buyers' Loss on Resale," 34 Taxes 411 (1956); Huston, "Tie-in Sales: Treatment of Loss on Resale of Property Purchased for the Purpose of Obtaining Other Property," 10 Tax L.Rev. 145 (1954).

This has frequently been applied to the purchaser's own notes. See, *e. g., Whitlow v. Commissioner*, 82 F.2d 569 (C.C.A.8th, 1936). Is this consistent with *Schlemmer v. United States, supra* p. 446, where the seller is on the cash basis? Where the obligations have no fair market value, then under sec. 1.453–6(a)(2), the payments are applied against the basis as received, and are all income when the basis has been exhausted. But note that, "Only in rare and extraordinary cases does property have no fair market value."

In *Burnet v. Logan*, 283 U.S. 404 (1931), the taxpayer sold stock for part cash, and a promise to pay sixty cents a ton for ore removed from a certain mine. The Court held that there was no income until the full amount of the basis had been recovered, saying (p. 413): "The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921, all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture."

Apparently the gain on the sale of real property (or other property) may be deferred by selling it on land contract. In such a case the purchaser's promise is not regarded as the equivalent of cash. A case holding that there is no gain on such a transaction until the payments actually received exceed the vendor's basis is *Estate of Wilson Critzer*, T.C.Memo., Nov. 30, 1954.

See Desmond, "Sales of Property Under the Deferred Payment Method," 32 Taxes 40 (1954); Andro, "Non-Commercial Annuities—Income Tax Consequences to the Transferor Who Exchanges Property in Return for an Annuity," 9 Tax L.Rex. 85 (1953); Fallon, "Deferred Payments as Taxable Income," 18 Corn.L.Q. 564 (1933).

MILLER v. UNITED STATES

United States Court of Appeals, Sixth Circuit, 1956. 235 F.2d 553.

MARTIN, CIRCUIT JUDGE. The United States District Court denied recovery in an action brought by appellants for refund, with interest, of income taxes and excess profits taxes paid by Harold W. Miller as sole transferee and stockholder of Melrose Manor Corporation, for 1946 and 1947, and by Miller and his wife, jointly, for refund with interest of income taxes paid by them for the years 1948, 1949 and 1950.

The district court upheld the determination of the Commissioner of Internal Revenue that the second-mortgage notes held by

Melrose Manor Corporation at the end of the fiscal year 1946, in the aggregate amount of $55,912, had a fair market value at that time of twenty-five percent of the face value of the notes; and that, therefore, a deficiency in tax in the amount of $13,978 had properly been assessed.

Likewise, the district court upheld a determination by the commissioner of a deficiency in the income tax of Miller amounting to $4,633.26 for 1947, based upon the proposition that the second-mortgage notes had a fair market value of twenty-five percent of their face value during that year. . . .

Briefly stated, the salient facts are that Harold W. Miller, a prominent real estate man and builder in Louisville, organized a Kentucky corporation in 1942 for the purpose of building houses for defense plant workers. Most of these houses were sold in 1946 and 1947 under a twenty-five-year Federal Housing Administration first-mortgage plan. During 1946, forty houses were sold for an aggregate sum of more than $285,000, in consequence of which second-mortgage notes for nearly $56,000 were acquired by the corporation. When the corporation was dissolved in the spring of 1947, its entire assets, including $66,734.56 of second-mortgage notes, were transferred to Miller as its sole stockholder.

The corporation reported no income from the second-mortgage notes received by it in the fiscal year 1946 and during 1947 to the time of its dissolution; but, in each tax returned filed by it, a notation was made in relation to the second-mortgage notes: "Deferred income collections credited to income as received." In his 1947 tax return and his returns for all subsequent years, Harold W. Miller returned, computed and paid taxes on the basis that the second-mortgage notes had no fair market value when received by him in 1947. He paid income taxes on the second-mortgage notes during the respective fiscal years in which he collected on them. Mortgages securing the second-mortgage notes were all inferior to first mortgages based on ninety percent of the appraised value of the property by which they were secured. The amortization of the first mortgages extended over a twenty-five-year period.

Among the fact findings of the district court was the following: "In the fall of 1946, Harold W. Miller testified, that desiring to consolidate his financial position, he caused both Melrose Manor Corporation and the Will B. Miller Company, both of which corporations he controlled, to offer for sale all of the second mortgage notes held by both corporations. This offering was made to banks, investment houses, mortgage companies, and real estate brokers. Without exception, the replies he received were that none of them was interested in purchasing the notes and they be-

lieved no market could be found for them. Miller, who had been in the real estate business for over thirty years and three disinterested witnesses, who likewise were experienced real estate dealers, testified that none of the second mortgage notes held by the Melrose Manor Corporation during the period June 1, 1945 to May 31, 1946, and March 26, 1947, had any fair market value.

"No witnesses or other proof were offered by defendants to show the basis for its contention that the notes had a market value of twenty-five percent or any value."

The applicable Revenue Act provides that the amount realized from the sale of property shall be the sum of money received, plus the fair market value of property (other than money) received. In upholding the determination of the commissioner that the second-mortgage notes had a fair market value of twenty-five percent at the time of their distribution to Miller, the district judge observed that subsequent payment of substantially $50,000 through the year 1950 would indicate that the commissioner was correct, "though it must be readily conceded that the evidence in the case, aside from the agreement as to payments subsequent to 1946, is to the effect that there was no market value on the second mortgages in 1943 and 1944." . . .

The opinion of the district court was thus concluded [130 F. Supp. 918]: "When the Commissioner made the assessment here involved in 1952, he had the advantage of the experience of the second mortgage notes and knew that substantially $50,000 had been paid. With this information, it could not be said that his estimate of value of twenty-five percent of the face amount of the securities was not a fair appraisal. Certainly, it could not be held to be clearly erroneous, because in 1947, the witnesses who testified in this case thought that the securities had no fixed or fair market value. . . . "

In the light of established facts in this case, we are not in accord with the district court's conclusion. We think that his ultimate finding of fact was clearly erroneous. If negotiable securities such as mortgage notes are shown by uncontroverted evidence to have had no fair market value at the time they were received in trade, they should not be assumed retrospectively to have had an actual market value contrary to the realities of the case merely because the notes were subsequently—in large part—collected when due.

The taxpayer in the present controversy made no attempt whatever to escape or avoid legitimate taxation. He paid income taxes upon the full amount realized from the second-mortgage notes as and when he collected payment of them. Experience has demonstrated that second-mortgage notes, when subordinated to

first mortgages to the extent of ninety percent of the value of the property, are highly speculative securities. It is easily understandable, therefore, that there could be no fair market value for such second-mortgage securities when received. If foresight were on a par with hindsight, there would be few losers in the speculative market place. Holders of second mortgages during the period from 1929 to 1932 could hardly be convinced that their second-mortgage real estate notes then had any fair market value. We think the action of the commissioner who placed a twenty-five percent valuation upon the second-mortgage notes in controversy was arbitrary, clearly erroneous, and contrary to practical considerations, which should be applied in determining the fair market value of negotiable securities. . . .

The judgment of the district court is reversed; and the cause is remanded with directions that the refund claims of appellants be allowed in conformity with the principles declared in this opinion.

Notes

(A) When the second mortgage notes are later collected, is the amount ordinary income or capital gain? See the further proceedings in the principal case. *Miller v. United States,* 262 F.2d 584 (C.A.6th, 1958), aff'g, 155 F.Supp. 767 (W.D.Ky.1957). See also *Osenbach v. Commissioner,* 198 F.2d 235 (C.A.4th, 1952). Note that sec. 1232 does not apply where the obligations are not issued by a corporation.

Would the result be any different if the taxpayer sold the obligations prior to payment rather than receiving payment direct from the obligor?

(B) In *Kuehner v. Commissioner of Internal Revenue,* 214 F.2d 437 (C.A.1st, 1954), it appeared that the taxpayer owned 50 shares of stock. In 1947 she entered into an agreement with a trust company and with X, under which she "herewith" delivered her stock to the trust company, and agreed to sell 10 shares of the stock to X in 1948, and 10 shares each year thereafter through 1952, for a payment of $13,000 in each of those years. By the same agreement, X agreed to buy the stock. At the same time, and pursuant to the agreement, X transferred $65,000 to the trustee; the agreement provided that the trustee was to invest this by deposit in banks or by purchase of U. S. government bonds. Interest received by the trustee was payable to the taxpayer. Dividends received on the stock were to be applied against the purchase price. Voting rights on the stock were transferred to X. The agreement was carried out, 10 shares of stock being delivered to X each year, and $13,000 paid to the taxpayer.

The court held that the entire amount of gain was taxable in 1947. The transfer of the shares in that year constituted a sale, and the rights received by the taxpayer in that year constituted "property" the fair market value of which was $65,000. The court said that X's "promise to pay was secured, unconditioned and fixed in amount, and thus could have been properly regarded by the Tax Court as the 'equivalent of cash.' "

(C) The owner of property which had a basis of $70,000 contracted to sell it in 1929 for $185,000. The buyer paid $35,000 in 1929 and $20,000 in 1930 pursuant to the contract. In 1931 the buyer defaulted. In 1933 the seller started suit for specific performance. This ended in 1934 with a decree denying specific performance because of the delay in starting suit, but holding that the seller might keep the payments made. What income resulted to the seller from this transaction, and when was it taxable? *Doyle v. Commissioner,* 110 F.2d 157 (C.C.A.2d, 1940). See also *Hunter v. Commissioner,* 140 F.2d 954 (C.C.A.5th, 1944).

H. BASIS

Secs. 1011–1022 of the 1954 Code, and corresponding provisions of the Income Tax Regulations

"Basis" is a word of art in tax law.

Section 1001(a) of the 1954 Code provides that the amount of gain or loss on the sale or exchange of property shall be determined by the relation of the "amount realized" to the "adjusted basis" of the property as determined under sec. 1011. Under sec. 1012, the basis of property is its "cost"—except as otherwise provided in four specified subchapters. The exceptions are numerous, and of great importance; they must be understood. Yet in numerically the largest proportion of the cases, the basic provision remains unqualified and the basis is "cost." Ordinarily the ascertainment of cost presents few problems, but there are a number of possible difficulties. See Greenbaum, "Basis of Property Shall Be the Cost of Such Property—How Is Cost Defined?" 3 Tax L.Rev. 351 (1948).

The adjustments to basis which must be made to obtain "adjusted basis" are detailed in sec. 1016.

Property Acquired from a Decedent

Sec. 1014 of the 1954 Code

As provided in sec. 1014, the basis of property acquired from a decedent is "the fair market value of such property at the date of the decedent's death." [1] This section is now fairly comprehensive and clear. It has not always been that way.

For many years, the corresponding provision, which was found in sec. 113(a)(5) of the 1939 Code, provided that "if the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition." This

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[1] Subject to the last clause of sec. 1014(a), which covers the cases where the optional valuation date has been elected under sec. 811(j) of the 1939 Code, or sec. 2032 of the 1954 Code.

left two major uncertainties: (1) What was "the time of such acquisition"? And (2) what was the scope of "bequest, devise, or inheritance, or by the decedent's estate from the decedent"?

(1) In *Brewster v. Gage,* 280 U.S. 327 (1930), the taxpayer was the residuary legatee of the decedent's estate. Under the state law, the decedent's property passed to the control of his executor; after administration (collecting the assets and paying the debts) the remaining property was turned over to the taxpayer about two years after the decedent's death. The question was what was the time of the taxpayer's acquisition of the property. It was held that the controlling date for basis purposes was the date of the decedent's death.

In *Helvering v. Reynolds,* 313 U.S. 428 (1941), this result was extended to a contingent remainderman. The decedent died leaving his property on trust for A for life, with remainder to such of the children of A as shall survive him. A number of years later A died, and B was one of his surviving children. B received a distribution of property from the trustee of the trust. It was held that B's basis for this property was the value on the date of the original decedent's death.

(2) In *Lang v. Commissioner,* 289 U.S. 109 (1933), a husband and wife had acquired property as tenants by the entirety. The husband died, and the wife thereafter sold the property. The court held that the wife had not acquired the property by "bequest, devise, or inheritance," so that her basis was not determined under sec. 113(a)(5), but remained the "cost" of the property.

The statute did contain a provision applicable to property which passed from the decedent through a revocable trust; but there was no provision applicable to cases where the property had been transferred through an irrevocable trust, with the decedent retaining a life estate.[2]

Community property. A provision was added to the 1939 Code in 1948, relating to the basis of community property taken by a surviving spouse. Prior to this amendment such property had as its basis its cost (or other basis) since it was regarded as always owned by the survivor and not acquired by the death of the other spouse. This presented a serious problem in connection with the marital deduction, when the effort was made to equalize taxes in community property and common law states by the Revenue

[2] See Marshall, "Basis of Property Subject to Estate Tax under I.R.C. Sections 811(c) and 811(d)," 26 So.Calif.L.Rev. 111 (1953); Rice, "Critical Problems in the Application of I.R.C. Section 112(b)(5)." 1 U.S.C.L.Rev. 30 (1953).

Act of 1948. By section 113(a)(5) property acquired by death took as its basis the value at the date of death (or optional valuation date). But property which received the marital deduction paid no estate tax. Should it get a new basis at death? At first blush it would seem that it should not, and that it should take cost (or other basis) as its basis in the hands of the survivor, as in the community property states. But it is extremely difficult to draft such a provision, as the marital deduction is a lump sum in dollars, and does not depend on the passage of specific property.

The dilemma was resolved by extending the basis at date of death rule to community property taken by the surviving spouse. It is not clear, however, that this has been enough to equalize the situation between the community property and the common law states. Apparently the community property states still have the advantage because of the facility with which community property may be transformed into a joint tenancy or a tenancy in common, in most states.

These questions have been rather thoroughly resolved by the provisions of sec. 1014 of the 1954 Code. The "time of such acquisition" phrase is gone, and instead it is expressly provided that the basis in these cases shall be the value "at the date of the decedent's death." And the phrase "bequest, devise, or inheritance, or by the decedent's estate from the decedent" is considerably expanded in sec. 1014(b). The effect is to provide a basis of value at the date of death for all property which is required to be included in the estate of the decedent for estate tax purposes (plus some—community property—which is not included in the decedent's estate). Although the language of the statute does not seem wholly clear, the committee reports make it clear that this is applicable to property transferred by the decedent in contemplation of death. See Chirelstein, "Some Problems of Basis and the Proposed Regulations," 35 Taxes 151 (1957).

Problems

(A) Suppose a man buys property for $1,000, and dies when it is worth $2,000. It is later sold for $2,500. Who pays the tax on the spread from $1,000 to $2,000? What is the reason for this "gap" in the taxability of capital gain? Is it justified? [1] Does it have any economic consequences?

(B) Is the valuation reached for estate tax purposes conclusive in determining the basis for income tax? See *Augustus v. Commissioner,* 40 B.T.A. 1201 (1940), aff'd on other grounds, 118

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[1] An effort by the Treasury in 1942 to have the law changed so that the decedent's basis would carry forward for income tax purposes (see Hearings Before the Committee on Ways and Means, Revenue Revision of 1942, p. 89–90) made no progress.

F.2d 38 (C.C.A.6th, 1941); sec. 1.1014–1 of the Income Tax Regulations. But see *Ford v. United States,* 276 F.2d 17 (Ct.Cls. 1960).

(C) Eight stockholders in a family corporation each owned 12 of its 96 shares of stock. One of them died, and left his 12 shares to the corporation. He also left certain other property to the corporation. What is the effect of this on the basis of the stock held by the survivors? In *Diebold v. Commissioner,* 194 F.2d 266 (C.A.3d, 1952), the court held that the basis of the stock of a survivor was his basis on his original one-eighth interest, plus the fair market value of his one-seventh interest in the one-eighth which was bequeathed to the corporation. It was also held that the bequest of other property to the corporation did not affect the basis of the stock to the survivors. Is the first result sound? Is there any basis for the distinction made by the second result?

(D) X died, leaving stock which was worth $100 per share at the time of his death. X's will provided that A might buy the stock for $75 per share. A did so and later sold the stock for $120 a share. What is A's basis? See *Mack v. Commissioner,* 148 F.2d 62 (C.C.A.3d, 1945), cert. den., 326 U.S. 719 (1945).

(E) The decedent left notes which were worthless at his death. Thereafter the notes were paid in full to the executor. Was this taxable income? *Helvering v. Roth,* 115 F.2d 239 (C.C.A.2d, 1940), noted in 54 Harv.L.Rev. 699 (1941).

(F) In *McCullough v. Commissioner,* 153 F.2d 345 (C.C.A.2d, 1946), A died leaving stock to a trustee. The trustee received stock dividends on the stock, some of which were distributed to the life tenant under the so-called Pennsylvania rule of apportioning receipts on sales of stock. The life tenant sold the stock so received. The court held that the shares in question were not acquired by "bequest," and that their basis was their value when they were received by the taxpayer. Would this result still follow under the 1954 Code?

(G) A will left securities to trustees with directions to pay $5,000,000 to Louise when she reached the age of forty, with authority to substitute securities of equal value at the date of payment. The trustees discharged $3,200,000 of the legacy with securities which they had received from the decedent's estate, and which had a value of $1,200,000 at the date of the decedent's death. Did the trust realize income from the transaction? *Kenan v. Commissioner,* 114 F.2d 217 (C.C.A.2d, 1940), noted in 25 Minn.L.Rev. 393 (1941); *Suisman v. Eaton,* 15 F.Supp. 113 (D. Conn. 1935), aff'd (mem.) 83 F.2d 1019 (C.C.A.2d, 1936), cert. den., 299 U.S. 573 (1936).[2] Where no pecuniary amount is stated, but the will directs the distribution of a portion of the principal, or certain designated property, at a later date by which time its value has gone up or down, see Rev.Rul. 55–117, 1955–1 Cum. Bull. 233.

The principle that the payment of a pecuniary legacy may result in capital gain or loss (where the property used to pay it has

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[2] See Roberts and Muller, "Constructive Receipt of Income by Estates and Trusts Through Distribution in Kind to Beneficiaries," 4 Tax L.Rev. 372 (1949).

a different basis than the amount of the legacy) has an important application in the case of marital deduction trusts where the amount of the gift is expressed in a formula, often designed to reach the maximum amount of the marital deduction under the estate tax, which, in final analysis, amounts to a gift of a "dollar amount." In such a case, both a ruling and the regulations state that there will be gain or loss on the use of securities of the estate to discharge the legacy. See Rev.Rul. 56–270, 1956–1 Cum.Bull. 325; sec. 1.1014–4(a)(3) of the Income Tax Regulations.

(H) Note the provisions in sec. 1014(b)(9) under which the "basis at date of death" rule is applicable in the case of inter vivos transfers which are made under such circumstances that the property transferred has been included in the transferor's gross estate for estate tax purposes. Thus where property was transferred on a trust which could be revoked with the consent of the trustees, who had no adverse interests, it was held that the basis of the property, after the death of the transferor, was its value at the date of her death. *Hazel B. Beckman Trust,* 26 T.C. 1172 (1956). But cf. *Rosalie W. Post,* 26 T.C. 1055 (1956). Both of these cases arose under sec. 113(a)(5) of the 1939 Code, which was similar in purpose to sec. 1014(b)(9) of the 1954 Code, but not as broad in scope.

For consideration of one aspect of the problem, see "Basis Problems under Section 1014(b)(9) Resulting from the Death of the Settlor-Reversioner of an Inter-Vivos Trust," 23 U. of Chi.L. Rev. 672 (1956). See also Rev.Rul. 59–86, cited at page 635, below.

Property Acquired by Gift, and Through Transfers in Trust

Sec. 1015 of the 1954 Code

The constitutionality of the provision now found in sec. 1015(a) of the 1954 Code, under which a donee takes his donor's basis (for purposes of computing gain), was sustained in *Taft v. Bowers,* 278 U.S. 478 (1929).[3] For the purpose of determining loss, the basis is either the donor's basis, or the fair market value at the time of the gift, whichever is lower.

Paragraph (d) of sec. 1015 was added to the Code by the Technical Amendments Act of 1958. It provides for adding to the basis of property when sold by the donee the amount of gift tax paid by the donor, but not so as to bring the basis above the fair market value at the date of the gift. What is the purpose of this provision? Is it desirable?

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[3] The Revenue Act of 1921, the first to contain the provision in question, was enacted on November 23, 1921. In Cooper v. United States, 280 U.S. 409 (1930), the gift was made on November 1, 1921, and the property was sold on November 7, 1921, at the same price as the value at the date of the gift. It was held that the statute could be validly applied in this situation.

Problem

A man buys property for $100. He gives it to his wife when it is worth $200. She holds it for a while, and then sells it for $150. Does she have gain or loss, and how much? Suppose it was first bought for $200, given to the wife when it was worth $100, and sold by her for $150. Would she have gain or loss, and how much?

FARID-ES-SULTANEH v. COMMISSIONER

United States Court of Appeals, Second Circuit, 1947. 160 F.2d 812.

CHASE, CIRCUIT JUDGE. The problem presented by this petition is to fix the cost basis to be used by the petitioner in determining the taxable gain on a sale she made in 1938 of shares of corporate stock. She contends that it is the adjusted value of the shares at the date she acquired them because her acquisition was by purchase. The Commissioner's position is that she must use the adjusted cost basis of her transferor because her acquisition was by gift. The Tax Court agreed with the Commissioner and redetermined the deficiency accordingly.

The pertinent facts are not in dispute and were found by the Tax Court as they were disclosed in the stipulation of the parties substantially as follows:

The petitioner is an American citizen who filed her income tax return for the calendar year 1938 with the Collector of Internal Revenue for the Third District of New York and in it reported sales during that year of 12,000 shares of the common stock of the S. S. Kresge Company at varying prices per share, for the total sum of $230,802.36 which admittedly was in excess of their cost to her. How much this excess amounted to for tax purposes depends upon the legal significance of the facts now to be stated.

In December 1923 when the petitioner, then unmarried, and S. S. Kresge, then married, were contemplating their future marriage, he delivered to her 700 shares of the common stock of the S. S. Kresge Company which then had a fair market value of $290 per share. The shares were all in street form and were to be held by the petitioner "for her benefit and protection in the event that the said Kresge should die prior to the contemplated marriage between the petitioner and said Kresge." The latter was divorced from his wife on January 9, 1924, and on or about January 23, 1924 he delivered to the petitioner 1800 additional common shares of S. S. Kresge Company which were also in street form and were to be held by the petitioner for the same purposes as were the first 700 shares he had delivered to her. On April 24, 1924, and when the petitioner still retained the possession of the stock so de-

livered to her, she and Mr. Kresge executed a written ante-nuptial agreement wherein she acknowledged the receipt of the shares "as a gift made by the said Sebastian S. Kresge, pursuant to this indenture, and as an ante-nuptial settlement, and in consideration of said gift and said ante-nuptial settlement, in consideration of the promise of said Sebastian S. Kresge to marry her, and in further consideration of the consummation of said promised marriage" she released all dower and other marital rights, including the right to her support to which she otherwise would have been entitled as a matter of law when she became his wife. They were married in New York immediately after the ante-nuptial agreement was executed and continued to be husband and wife until the petitioner obtained a final decree of absolute divorce from him on, or about, May 18, 1928. No alimony was claimed by, or awarded to her.

The stock so obtained by the petitioner from Mr. Kresge had a fair market value of $315 per share on April 24, 1924, and of $330 per share on, or about May 6, 1924 when it was transferred to her on the books of the corporation. She held all of it for about three years, but how much she continued to hold thereafter is not disclosed except as that may be shown by her sales in 1938. Meanwhile her holdings had been increased by a stock dividend of 50 per cent, declared on April 1, 1925; one of 10 to 1 declared on January 19, 1926; and one of 50 per cent, declared on March 1, 1929. Her adjusted basis for the stock she sold in 1938 was $10.66⅔ per share computed on the basis of the fair market value of the shares which she obtained from Mr. Kresge at the time of her acquisition. His adjusted basis for the shares she sold in 1938 would have been $0.159091.

When the petitioner and Mr. Kresge were married he was 57 years old with a life expectancy of 16½ years. She was then 32 years of age with a life expectancy of 33¾ years. He was then worth approximately $375,000,000 and owned real estate of the approximate value of $100,000,000.

The Commissioner determined the deficiency on the ground that the petitioner's stock obtained as above stated was acquired by gift within the meaning of that word as used in § 113(a) (2) of the Revenue Act of 1938, and, as the transfer to her was after December 31, 1920, used as the basis for determining the gain on her sale of it the basis it would have had in the hands of the donor. This was correct if the just mentioned statute is applicable, and the Tax Court held it was on the authority of *Wemyss v. Commissioner*, 324 U.S. 303, and *Merrill v. Fahs*, 324 U.S. 308.

The issue here presented cannot, however, be adequately dealt with quite so summarily. The *Wemyss* case determined the taxability to the transferor as a gift, under §§ 501 and 503 of the

Revenue Act of 1932, and the applicable regulations, of property transferred in trust for the benefit of the prospective wife of the transferor pursuant to the terms of an ante-nuptial agreement. It was held that the transfer, being solely in consideration of her promise of marriage, and to compensate her for loss of trust income which would cease upon her marriage, was not for an adequate and full consideration in money or money's worth within the meaning of § 503 of the statute, the Tax Court having found that the transfer was not one at arm's length made in the ordinary course of business. But we find nothing in this decision to show that a transfer, taxable as a gift under the gift tax, is ipso facto to be treated as a gift in construing the income tax law.

In *Merrill v. Fahs,* supra, it was pointed out that the estate and gift tax statutes are in pari materia and are to be so construed. *Estate of Sanford v. Commissioner of Internal Revenue,* 308 U.S. 39, 44. The estate tax provisions in the Revenue Act of 1916 required the inclusion in a decedent's gross estate of transfers made in contemplation of death, or intended to take effect in possession and enjoyment at or after death except when a transfer was the result of "a bona fide sale for a fair consideration in money or money's worth." Sec. 202(b), 39 Stat. 756, 777. The first gift tax became effective in 1924, and provided inter alia, that where an exchange or sale of property was for less than a fair consideration in money or money's worth the excess should be taxed as a gift. Rev.Act of 1924, § 320, 43 Stat. 314. While both taxing statutes thus provided, it was held, that a release of dower rights was a fair consideration in money or money's worth. *Ferguson v. Dickson,* 3 Cir., 300 F. 961, certiorari denied 266 U.S. 628; *McCaughn v. Carver,* 3 Cir., 19 F.2d 126. Following that, Congress in 1926 replaced the words "fair consideration" in the 1924 Act limiting the deductibility of claims against an estate with the words "adequate and full consideration in money or money's worth" and in 1932 the gift tax statute as enacted limited consideration in the same way. Rev.Act 1932, § 503. Although Congress in 1932 also expressly provided that the release of marital rights should not be treated as a consideration in money or money's worth in administering the estate tax law, Rev.Act of 1932, § 804, and failed to include such a provision in the gift tax statute, it was held that the gift tax law should be construed to the same effect. *Merrill v. Fahs, supra.*

We find in this decision no indication, however, that the term "gift" as used in the income tax statute should be construed to include a transfer which, if made when the gift tax were effective, would be taxable to the transferor as a gift merely because of the special provisions in the gift tax statute, defining and restricting consideration for gift tax purposes. A fortiori, it would seem that limitations found in the estate tax law upon according the

usual legal effect to proof that a transfer was made for a fair consideration should not be imported into the income tax law except by action of Congress.

In our opinion the income tax provisions are not to be construed as though they were in pari materia with either the estate tax law or the gift tax statutes. They are aimed at the gathering of revenue by taking for public use given percentages of what the statute fixes as net taxable income. Capital gains and losses are, to the required or permitted extent, factors in determining net taxable income. What is known as the basis for computing gain or loss on transfers of property is established by statute in those instances when the resulting gain or loss is recognized for income tax purposes and the basis for succeeding sales or exchanges will, theoretically at least, level off tax-wise any hills and valleys in the consideration passing either way on previous sales or exchanges. When Congress provided that gifts should not be treated as taxable income to the donee there was, without any correlative provisions fixing the basis of the gift to the donee, a loophole which enabled the donee to make a subsequent transfer of the property and take as the basis for computing gain or loss its value when the gift was made. Thus it was possible to exclude from taxation any increment in value during the donor's holding and the donee might take advantage of any shrinkage in such increment after the acquisition by gift in computing gain or loss upon a subsequent sale or exchange. It was to close this loophole that Congress provided that the donee should take the donor's basis when property was transferred by gift. Report of Ways and Means Committee (No. 350, P. 9, 67th Cong., 1st Sess.). This change in the statute affected only the statutory net taxable income. The altered statute prevented a transfer by gift from creating any change in the basis of the property in computing gain or loss on any future transfer. In any individual instance the change in the statute would but postpone taxation and presumably would have little effect on the total volume of income tax revenue derived over a long period of time and from many taxpayers. Because of this we think that a transfer which should be classed as a gift under the gift tax law is not necessarily to be treated as a gift income-tax-wise. Though such a consideration as this petitioner gave for the shares of stock she acquired from Mr. Kresge might not have relieved him from liability for a gift tax, had the present gift tax then been in effect, it was nevertheless a fair consideration which prevented her taking the shares as a gift under the income tax law since it precluded the existence of a donative intent.

Although the transfers of the stock made both in December 1923, and in the following January by Mr. Kresge to this taxpayer are called a gift in the ante-nuptial agreement later execut-

ed and were to be for the protection of his prospective bride if he died before the marriage was consummated, the "gift" was contingent upon his death before such marriage, an event that did not occur. Consequently, it would appear that no absolute gift was made before the ante-nuptial contract was executed and that she took title to the stock under its terms, viz.: in consideration for her promise to marry him coupled with her promise to relinquish all rights in and to his property which she would otherwise acquire by the marriage. Her inchoate interest in the property of her affianced husband greatly exceeded the value of the stock transferred to her. It was a fair consideration under ordinary legal concepts of that term for the transfers of the stock by him. *Ferguson v. Dickson, supra; McCaughn v. Carver, supra.* She performed the contract under the terms of which the stock was transferred to her and held the shares not as a donee but as a purchaser for a fair consideration. . . .

Decision reversed.

CLARK, CIRCUIT JUDGE (dissenting). The opinion accepts two assumptions, both necessary to the result. The first is that definitions of gift under the gift and estate tax statutes are not useful, in fact are directly opposed to, definitions of gift under the capital-gains provision of the income tax statute. The second is that the circumstances here of a transfer of the stock some months before the marriage showed, contrary to the conclusions of the Tax Court, a purchase of dower rights, rather than a gift. The first I regard as doubtful; the second, as untenable.

It is true that *Commissioner of Internal Revenue v. Wemyss*, 324 U.S. 303, and *Merrill v. Fahs*, 324 U.S. 308, which would require the transactions here to be considered a gift, dealt with estate and gift taxes. But no strong reason has been advanced why what is a gift under certain sections of the Revenue Code should not be a gift under yet another section. As a matter of fact these two cases indicate that the donative intent of the common law is not an essential ingredient of a gift for tax purposes. Conversely love, affection, and the promise of future marriage will not be consideration adequate to avoid the gift tax. If that is so, it would seem that these should not be sufficient to furnish new and higher cost bases for computing capital gains on ultimate sale. The Congressional purpose would seem substantially identical—to prevent a gap in the law whereby taxes on gifts or on capital gains could be avoided or reduced by judicious transfers within the family or intimate group.

But decision on that point might well be postponed, since, to my mind, the other point should be decisive. Kresge transferred the stock to petitioner more than three months before their marriage. Part was given when Kresge was married to

another woman. At these times petitioner had no dower or other rights in his property. If Kresge died before the wedding, she could never secure dower rights in his lands. Yet she would nevertheless keep the stock. Indeed the specifically stated purpose of the transfer was to protect her against his death prior to marriage. It is therefore difficult to perceive how her not yet acquired rights could be consideration for the stock. . . .

Note

See "Federal Income and Gift Taxation of Marital Property Settlements," 1959 Duke L.J. 616.

Other Basis Provisions

There are numerous other provisions of the statute affecting the basis of property.

Value on March 1, 1913. One of these, of ancient vintage, is that relating to the basis of property acquired before March 1, 1913, when the income tax went into effect. See sec. 1053 of the 1954 Code.

Problem

The taxpayer bought stock in 1906 for $1,000. On March 1, 1913, it was worth $2,000. In 1914, the corporation was liquidated, and the taxpayer received $2,000. Did he have any taxable gain? *Lynch v. Turrish,* 247 U.S. 221 (1918). What would be the result if the stock were held and sold in 1954 for $1,500?

Corporate reorganizations and adjustments. Sec. 1011 of the 1954 Code, relating to basis, refers to the provisions of subchapter C (relating to corporate distributions and adjustments). This subchapter includes secs. 301 to 395 of the 1954 Code. The principal basis provision is found in sec. 358—but there are others. The general effect of sec. 358 is to provide that wherever there is a transfer on which no gain or loss is recognized, the property acquired takes the same basis as that of the property which was given up on the exchange. See also sec. 362 which has a similar effect with respect to transfers to corporations.

Problem

A man buys property for $5,000. When it is worth $10,000, he transfers it to a corporation in exchange for all the corporation's stock. The corporation sells it for $8,000. Does the corporation have gain or loss, and how much? The man sells his stock for $7,500. Does he have gain or loss, and how much?

Dividends. Sec. 301(d) of the 1954 Code provides the rule for basis of property distributed by a corporation to its shareholders. In connection with the rule where the recipient of the distribution is a corporation, see also the reference at pages 674–675 in the following chapter.

Note

T owned a tract of land with valuable mineral rights. Its basis for these rights was zero. T transferred the rights to a wholly owned subsidiary. It then arranged to sell the rights, and in order to get the rights back into T's hands, the subsidiary declared the rights as a dividend in kind. On their receipt, T conveyed them to the purchaser. T contended that it had received a dividend subject to the 85% dividends received credit (this was before the 1954 Code), and that it had no gain on the sale, since its basis for the rights was their fair market value, after the dividend, and it had sold them at that figure. It was held that the transfer of the rights to the subsidiary was not made for any business purpose, and that the reacquisition by T did not result in a stepped-up basis. *Weyl-Zuckerman & Co. v. Commissioner,* 232 F.2d 214 (C.A.9th, 1956).

Partnership property. Another of the groups of sections to which reference is made in sec. 1011 is subchapter K, relating to partners and partnerships. This subchapter includes secs. 701 through 771. The principal basis provisions are in secs. 722, 723, 732, 733, 742, and 743. These are very complicated provisions. They are new in the 1954 Code, and though difficult, should go far to relieve the great uncertainty which has long surrounded this area. For a case under the earlier law, see *Helvering v. Walbridge,* 70 F.2d 683 (C.C.A.2d, 1934), cert. den., 293 U.S. 594 (1934). See also Willis, Handbook of Partnership Taxation (1957) chapters 15, 16, 22.[3]

CRANE v. COMMISSIONER

Supreme Court of the United States, 1947. 331 U.S. 1.

MR. CHIEF JUSTICE VINSON delivered the opinion of the Court.

The question here is how a taxpayer who acquires depreciable property subject to an unassumed mortgage, holds it for a period, and finally sells it still so encumbered, must compute her taxable gain.

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[3] Earlier references include "Some Tax Consequences of Partnership Readjustments," 67 Harv.L.Rev. 860 (1954); Wakefield, "Basis for Partners under the Revenue Act of 1934," 13 Tax Mag. 447 (1935); "Taxation of Contributions of Appreciated Property to Partnership Capital in Kind," 86 U. of Pa.L.Rev. 413 (1938); Magill, Taxable Income 134–138 (Rev. ed. 1945); Rabkin and Johnson, "The Partnership under the Federal Tax Laws," 55 Harv.L.Rev. 909, 911–920 (1942); Roehner, "Can Cash Have a Basis of Less than Cash?" 27 Taxes 517 (1949).

Petitioner was the sole beneficiary and the executrix of the will of her husband, who died January 11, 1932. He then owned an apartment building and lot subject to a mortgage,[1] which secured a principal debt of $255,000.00 and interest in default of $7,042.50. As of that date, the property was appraised for federal estate tax purposes at a value exactly equal to the total amount of this encumbrance. Shortly after her husband's death, petitioner entered into an agreement with the mortgagee whereby she was to continue to operate the property—collecting the rents, paying for necessary repairs, labor, and other operating expenses, and reserving $200.00 monthly for taxes —and was to remit the net rentals to the mortgagee. This plan was followed for nearly seven years, during which period petitioner reported the gross rentals as income, and claimed and was allowed deductions for taxes and operating expenses paid on the property, for interest paid on the mortgage, and for the physical exhaustion of the building. Meanwhile, the arrearage of interest increased to $15,857.71. On November 29, 1938, with the mortgagee threatening foreclosure, petitioner sold to a third party for $3,000.00 cash, subject to the mortgage, and paid $500.00 expenses of sale.

Petitioner reported a taxable gain of $1,250.00. Her theory was that the "property" which she had acquired in 1932 and sold in 1938 was only the equity, or the excess in the value of the apartment building and lot over the amount of the mortgage. This equity was of zero value when she acquired it. No depreciation could be taken on a zero value.[2] Neither she nor her vendee ever assumed the mortgage, so, when she sold the equity, the amount she realized on the sale was the net cash received, or $2,500.00. This sum less the zero basis constituted her gain, of which she reported half as taxable on the assumption that the entire property was a "capital asset".[3]

The Commissioner, however, determined that petitioner realized a net taxable gain of $23,767.03. His theory was that the "property" acquired and sold was not the equity, as petitioner claimed, but rather the physical property itself, or the owner's rights to possess, use, and dispose of it, undiminished by the mortgage. The original basis thereof was $262,042.50, its appraised value in 1932. Of this value $55,000.00 was al-

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1 The record does not show whether he was personally liable for the debt.

2 This position is, of course, inconsistent with her practice in claiming such deductions in each of the years the property was held. The deductions so claimed and allowed by the Commissioner were in the total amount of $25,-500.00.

3 See § 117(a), (b), Revenue Act of 1938, c. 289, 52 Stat. 447. Under this provision only 50% of the gain realized on the sale of a "capital asset" need be taken into account, if the property had been held more than two years.

locable to land and $207,042.50 to building.[4] During the period that petitioner held the property, there was an allowable depreciation of $28,045.10 on the building,[5] so that the adjusted basis of the building at the time of sale was $178,997.40. The amount realized on the sale was said to include not only the $2,500.00 net cash receipts, but also the principal amount[6] of the mortgage subject to which the property was sold, both totaling $257,500.00. The selling price was allocable in the proportion, $54,471.15 to the land and $203,028.85 to the building.[7] The Commissioner agreed that the land was a "capital asset", but thought that the building was not.[8] Thus, he determined that petitioner sustained a capital loss of $528.85 on the land, of which 50% or $264.42 was taken into account, and an ordinary gain of $24,031.45 on the building, or a net taxable gain as indicated.

The Tax Court agreed with the Commissioner that the building was not a "capital asset." In all other respects it adopted petitioner's contentions, and expunged the deficiency.[9] Petitioner did not appeal from the part of the ruling adverse to her, and these questions are no longer at issue. On the Commissioner's appeal, the Circuit Court of Appeals reversed, one judge dissenting.[10] We granted certiorari because of the importance of the questions raised as to the proper construction of the gain and loss provisions of the Internal Revenue Code.[11]

The 1938 Act,[12] § 111(a), defines the gain from "the sale or other disposition of property" as "the excess of the amount realized therefrom over the adjusted basis provided in § 113 (b). . . ." It proceeds, § 111(b), to define "the amount realized from the sale or other disposition of property" as "the

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4 The parties stipulated as to the relative parts of the 1932 appraised value and of the 1938 sales price which were allocable to land and building.

5 The parties stipulated that the rate of depreciation applicable to the building was 2% per annum.

6 The Commissioner explains that only the principal amount, rather than the total present debt secured by the mortgage, was deemed to be a measure of the amount realized, because the difference was attributable to interest due, a deductible item.

7 See supra, note 4.

8 See § 117(a)(1), Revenue Act of 1938, supra.

9 3 T.C. 585. The Court held that the building was not a "capital asset" within the meaning of § 117(a) and that the entire gain on the building had to be taken into account under § 117(b), because it found that the building was of a character subject to physical exhaustion and that petitioner had used it in her trade or business.

But because the Court accepted petitioner's theory that the entire property had a zero basis, it held that she was not entitled to the 1938 depreciation deduction on the building which she had inconsistently claimed.

For these reasons, it did not expunge the deficiency in its entirety.

10 153 F.2d 504.

11 328 U.S. 826.

12 All subsequent references to a revenue act are to this Act unless otherwise indicated. The relevant parts of the gain and loss provisions of the Act and Code are identical.

sum of any money received plus the fair market value of the property (other than money) received." Further, in § 113 (b), the "adjusted basis for determining the gain or loss from the sale or other disposition of property" is declared to be "the basis under subsection (a), adjusted . . . [(1) (B)] . . . for exhaustion, wear and tear, obsolescence, amortization . . . to the extent allowed (but not less than the amount allowable). . . . " The basis under subsection (a) "if the property was acquired by . . . devise . . . or by the decedent's estate from the decedent", § 113(a)(5), is "the fair market value of such property at the time of such acquisition."

Logically, the first step under this scheme is to determine the unadjusted basis of the property, under § 113(a)(5), and the dispute in this case is as to the construction to be given the term "property". If "property", as used in that provision, means the same thing as "equity", it would necessarily follow that the basis of petitioner's property was zero, as she contends. If, on the contrary, it means the land and building themselves, or the owner's legal rights in them, undiminished by the mortgage, the basis was $262,042.50.

We think that the reasons for favoring one of the latter constructions are of overwhelming weight. In the first place, the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses.[13] The only relevant definitions of "property" to be found in the principal standard dictionaries [14] are the two favored by the Commissioner, *i. e.*, either that "property" is the physical thing which is a subject of ownership, or that it is the aggregate of the owner's rights to control and dispose of that thing. "Equity" is not given as a synonym, nor do either of the foregoing definitions suggest that it could be correctly so used. Indeed, "equity" is defined as "the value of a property . . . above the total of the liens. . . ." [15] The contradistinction could hardly be more pointed. Strong countervailing considerations would be required to support a contention that Congress, in using the word "property", meant "equity", or that we should impute to it the intent to convey that meaning.[16]

In the second place, the Commissioner's position has the approval of the administrative construction of § 113(a)(5). With respect to the valuation of property under that section, Reg. 101, Art. 113(a)(5)-1, promulgated under the 1938 Act, pro-

13 Old Colony R. Co. v. Commissioner, 284 U.S. 552, 560.

14 See Webster's New International Dictionary, Unabridged, 2d Ed.; Funk & Wagnalls' New Standard Dictionary; Oxford English Dictionary.

15 See Webster's New International Dictionary, supra.

16 Crooks v. Harrelson, 282 U.S. 55, 59.

vided that "the value of property as of the date of the death of the decedent as appraised for the purpose of the federal estate tax . . . shall be deemed to be its fair market value. . . ." The land and building here involved were so appraised in 1932, and their appraised value—$262,042.50—was reported by petitioner as part of the gross estate. This was in accordance with the estate tax law [17] and regulations,[18] which had always required that the value of decedent's property, undiminished by liens, be so appraised and returned, and that mortgages be separately deducted in computing the net estate.[19] As the quoted provision of the Regulations has been in effect since 1918,[20] and as the relevant statutory provision has been repeatedly reenacted since then in substantially the same form,[21] the former may itself now be considered to have the force of law.[22]

Moreover, in the many instances in other parts of the Act in which Congress has used the word "property", or expressed the idea of "property" or "equity", we find no instances of a misuse of either word or of a confusion of the ideas.[23] In some parts of the Act other than the gain and loss sections, we find "property" where it is unmistakably used in its ordinary sense.[24] On the other hand, where either Congress or the Treasury intended to convey the meaning of "equity," it did so by the use of appropriate language.[25]

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[17] See §§ 202 and 203(a)(1), Revenue Act of 1916; §§ 402 and 403(a)(1), Revenue Acts of 1918 and 1921; §§ 302, 303(a)(1), Revenue Acts of 1924 and 1926; § 805, Revenue Act of 1932.

[18] See Reg. 37, Arts. 13, 14, and 47; Reg. 63, Arts. 12, 13, and 41; Reg. 68, Arts. 11, 13, and 38; Reg. 70, Arts. 11, 13, and 38; Reg. 80, Arts. 11, 13, and 38.

[19] See City Bank Farmers Trust Co. v. Bowers, 68 F.2d 909, cert. denied, 292 U.S. 644; Rodiek v. Helvering, 87 F.2d 328; Adriance v. Higgins, 113 F.2d 1013.

[20] See also Reg. 45, Art. 1562; Reg. 62, Art. 1563; Reg. 65, Art. 1594; Reg. 69, Art. 1594; Reg. 74, Art. 596; Reg. 77, Art. 596; Reg. 86, Art. 113(a)(5)–1(c); Reg. 94, Art. 113(a)(5)–1(c); Reg. 103, § 19.113(a)(5)–1(c); Reg. 111, § 29.113(a)(5)–1(c).

[21] § 202(a) (3), Revenue Act of 1921; § 204(a)(5), Revenue Act of 1924; § 204(a)(5), Revenue Act of 1926; § 113(a)(5), Revenue Act of 1928; § 113(a)(5), Revenue Act of 1932; § 113(a)(5), Revenue Act of 1934; § 113(a)(5), Revenue Act of 1936; § 113(a)(5), Revenue Act of 1938; § 113(a)(5), Internal Revenue Code.

[22] Helvering v. Reynolds Co., 306 U.S. 110, 114.

[23] Cf. Helvering v. Stockholms Bank, 293 U.S. 84, 87.

[24] Sec. 23(a)(1) permits the deduction from gross income of "rentals . . . required to be made as a condition to the continued use . . . for purposes of the trade or business, of *property* . . . in which he [the taxpayer] has no *equity*."

Sec. 23(1) permits the deduction from gross income of "a reasonable allowance for the exhaustion, wear and tear of *property* used in the trade or business. . . ."

See also § 303(a)(1), Revenue Act of 1926, c. 27, 44 Stat. 9; § 805, Revenue Act of 1932, c. 209, 47 Stat. 280.

[25] See § 23(a)(1), supra, note 24; § 805, Revenue Act of 1932, supra, note 24; § 3482, I.R.C.; Reg. 105, § 81.38. This provision of the Regulations,

A further reason why the word "property" in § 113(a) should not be construed to mean "equity" is the bearing such construction would have on the allowance of deductions for depreciation and on the collateral adjustments of basis.

Section 23(*l*) permits deduction from gross income of "a reasonable allowance for the exhaustion, wear and tear of property. . . ." Sections 23(n) and 114(a) declare that the "basis upon which exhaustion, wear and tear . . . are to be allowed" is the basis "provided in Sec. 113(b) for the purpose of determining the gain upon the sale" of the property, which is the § 113(a) basis "adjusted . . . for exhaustion, wear and tear . . . to the extent allowed (but not less than the amount allowable). . . ."

Under these provisions, if the mortgagor's equity were the § 113(a) basis, it would also be the original basis from which depreciation allowances are deducted. If it is, and if the amount of the annual allowances were to be computed on that value, as would then seem to be required,[26] they will represent only a fraction of the cost of the corresponding physical exhaustion, and any recoupment by the mortgagor of the remainder of that cost can be effected only by the reduction of his taxable gain in the year of sale.[27] If, however, the amount of the annual allowances were to be computed on the value of the property, and then deducted from an equity basis, we would in some instances have to accept deductions from a minus basis or deny deductions altogether.[28] The Commissioner also argues that taking the mortgagor's equity as the § 113(a) basis would require the basis to be changed with each payment on the mortgage,[29] and that the attendant problem of repeatedly recomputing basis and annual

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first appearing in 1937, T.D. 4729, 1937–1 Cum.Bull. 284, 289, permitted estates which were not liable on mortgages applicable to certain of decedent's property to return "only the value of the equity of redemption (or value of the property, less the indebtedness). . . ."

26 Secs. 23(n) and 114(a), in defining the "basis upon which" depreciation is "to be allowed", do not distinguish between basis as the minuend from which the allowances are to be deducted, and as the dividend from which the amount of the allowance is to be computed. The Regulations indicate that the basis of property is the same for both purposes. Reg. 101, Art. 23 (1)–4, 5.

27 This is contrary to Treasury practice, and to Reg. 101, Art. 23(1)–5, which provides in part:

"The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production."

See Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101.

28 So long as the mortgagor remains in possession, the mortgagee can not take depreciation deductions, even if he is the one who actually sustains the capital loss, as § 23(1) allows them only on property "used in the trade or business."

29 Sec. 113(b)(1)(A) requires adjustment of basis "for expenditures . . . properly chargeable to capital account. . . ."

allowances would be a tremendous accounting burden on both the Commissioner and the taxpayer. Moreover, the mortgagor would acquire control over the timing of his depreciation allowances.

Thus it appears that the applicable provisions of the Act expressly preclude an equity basis, and the use of it is contrary to certain implicit principles of income tax depreciation, and entails very great administrative difficulties.[30] It may be added that the Treasury has never furnished a guide through the maze of problems that arise in connection with depreciating an equity basis, but, on the contrary, has consistently permitted the amount of depreciation allowances to be computed on the full value of the property, and subtracted from it as a basis. Surely, Congress' long-continued acceptance of this situation gives it full legislative endorsement.[31]

We conclude that the proper basis under § 113(a)(5) is the value of the property, undiminished by mortgages thereon, and that the correct basis here was $262,042.50. The next step is to ascertain what adjustments are required under § 113(b). As the depreciation rate was stipulated, the only question at this point is whether the Commissioner was warranted in making any depreciation adjustments whatsoever.

Section 113(b)(1)(B) provides that "proper adjustment in respect of the property *shall in all cases be made* . . . for exhaustion, wear and tear . . . to the extent allowed (but not less than the amount allowable). . . . " The Tax Court found on adequate evidence that the apartment house was property of a kind subject to physical exhaustion, that it was used in taxpayer's trade or business, and consequently that the taxpayer would have been entitled to a depreciation allowance under § 23(l), except that, in the opinion of that Court, the basis of the property was zero, and it was thought that depreciation could not be taken on a zero basis. As we have just decided that the correct basis of the property was not zero, but $262,042.50, we avoid this difficulty, and conclude that an adjustment should be made as the Commissioner determined. . . .

At last we come to the problem of determining the "amount realized" on the 1938 sale. Section 111(b), it will be recalled, defines the "amount realized" from "the sale . . . of property" as "the sum of any money received plus the fair market

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30 Obviously we are not considering a situation in which a taxpayer has acquired and sold an equity of redemption only, i. e., a right to redeem the property without a right to present possession. In that situation, the right to redeem would itself be the aggregate of the taxpayer's rights and would undoubtedly constitute "property" within the meaning of § 113(a). No depreciation problems would arise. See note 28.

31 See note 22.

value of the property (other than money) received," and § 111 (a) defines the gain on "the sale . . . of property" as the excess of the amount realized over the basis. Quite obviously, the word "property," used here with reference to a sale, must mean "property" in the same ordinary sense intended by the use of the word with reference to acquisition and depreciation in § 113, both for certain of the reasons stated heretofore in discussing its meaning in § 113, and also because the functional relation of the two sections requires that the word mean the same in one section that it does in the other. If the "property" to be valued on the date of acquisition is the property free of liens, the "property" to be priced on a subsequent sale must be the same thing.

Starting from this point, we could not accept petitioner's contention that the $2,500.00 net cash was all she realized on the sale except on the absurdity that she sold a quarter-of-a million dollar property for roughly one per cent of its value, and took a 99 per cent loss. Actually, petitioner does not urge this. She argues, conversely, that because only $2,500.00 was realized on the sale, the "property" sold must have been the equity only, and that consequently we are forced to accept her contention as to the meaning of "property" in § 113. We adhere, however, to what we have already said on the meaning of "property," and we find that the absurdity is avoided by our conclusion that the amount of the mortgage is properly included in the "amount realized" on the sale.

Petitioner concedes that if she had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would be considered a part of the "amount realized" within the meaning of § 111(b).[32] The cases so deciding have already repudiated the notion that there must be an actual receipt by the seller himself of "money" or "other property," in their narrowest senses. It was thought to be decisive that one section of the Act must be construed so as not to defeat the intention of another or to frustrate the Act as a whole, and that the taxpayer was the "beneficiary" of the payment in "as real and substantial [a sense] as if the money had been paid it and then paid over by it to its creditors." [33]

Both these points apply to this case. The first has been mentioned already. As for the second, we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes

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32 United States v. Hendler, 303 U.S. 564; Brons Hotels, Inc., 34 B.T.A. 376; Walter F. Haass, 37 B.T.A. 948. See Douglas v. Wilcutts, 296 U.S. 1, 8.

33 See United States v. Hendler, supra, 303 U.S. at 566.

a benefit in the amount of the mortgage as well as the boot.[34] If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations.[35] If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

Therefore we conclude that the Commissioner was right in determining that petitioner realized $257,500.00 on the sale of his property. . . .

Petitioner contends that the result we have reached taxes her on what is not income within the meaning of the Sixteenth Amendment. If this is because only the direct receipt of cash is thought to be income in the constitutional sense, her contention is wholly without merit.[36] If it is because the entire transaction is thought to have been "by all dictates of commonsense . . . a ruinous disaster," as it was termed in her brief, we disagree with her premise. She was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain.[37] We

34 Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

35 For instance, this petitioner returned the gross rentals as her own income, and out of them paid interest on the mortgage, on which she claimed and was allowed deductions. See Reg. 77, Art. 141; Reg. 86, Art. 23(b)–1; Reg. 94, Art. 23(b)–1; Reg. 101, Art. 23(b)–1.

36 Douglas v. Wilcutts, supra, 296 U.S. at 9; Burnet v. Wells, 289 U.S. 670, 677.

37 In the course of the argument some reference was made, as by analogy to a situation in which a taxpayer acquired by devise property subject to a mortgage in an amount greater than the then value of the property, and later transferred it to a third person, still subject to the mortgage, and for a cash boot. Whether or not the difference between the value of the property on acquisition and the amount of the mortgage would in that situation constitute either statutory or constitutional income is a question which is different from the one before us, and which we need not presently answer.

have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the Act itself.

Affirmed.

MR. JUSTICE JACKSON, dissenting. The Tax Court concluded that this taxpayer acquired only an equity worth nothing. The mortgage was in default, the mortgage debt was equal to the value of the property, any possession by the taxpayer was forfeited and terminable immediately by foreclosure, and perhaps by a receiver *pendente lite.* Arguments can be advanced to support the theory that the taxpayer received the whole property and thereupon came to owe the whole debt. Likewise it is argued that when she sold she transferred the entire value of the property and received release from the whole debt. But we think these arguments are not so conclusive that it was not within the province of the Tax Court to find that she received an equity which at that time had a zero value. *Dobson v. Commissioner,* 320 U.S. 489; *Commissioner v. Scottish American Investment Co., Ltd.,* 323 U.S. 119. The taxpayer never became personally liable for the debt, and hence when she sold she was released from no debt. The mortgage debt was simply a subtraction from the value of what she did receive, and from what she sold. The subtraction left her nothing when she acquired it and a small margin when she sold it. She acquired a property right equivalent to an equity of redemption and sold the same thing. It was the "property" bought and sold as the Tax Court considered it to be under the Revenue Laws. We are not required in this case to decide whether depreciation was properly taken, for there is no issue about it here.

We would reverse the Court of Appeals and sustain the decision of the Tax Court.

MR. JUSTICE FRANKFURTER and MR. JUSTICE DOUGLAS join in this opinion.[38]

Notes

(A) In *Parker v. Delaney,* 186 F.2d 455 (C.A.1st, 1950), the taxpayer was a purchaser of the property (rather than a devisee), and took the property subject to a substantial mortgage, but without personal liability. The same result was reached—namely, that the basis of the property was its entire value, not reduced by the amount of the mortgage—but the court had considerable trouble fitting this into the statute, and in working out

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38 See Greenlee and Kramer, "The Mortgagor with a Negative Basis," 27 Taxes 887 (1949).

all of the implications of the *Crane* case. Judge Magruder, in a concurring opinion, suggested using the (nominal) value of the equity as basis, and working out the result of the gain on the sale through a "negative" basis. Is this sound?

See also *Commissioner v. Fortee Properties, Inc.*, 211 F.2d 915 (C.A.2d, 1954), which is similar.

(B) In *Virginian Hotel Corp. v. Helvering,* 319 U.S. 523 (1943), it was held that the basis must be adjusted for the full amount of depreciation deducted on prior tax returns, even though it was now agreed that the amount so deducted was excessive, and the deductions had given the taxpayer no tax benefit because it had no income apart from the depreciation deductions. Thus the Court held that depreciation deductions were "allowed" although they were not otherwise effective for tax purposes. There is a comment of the case in 56 Harv.L.Rev. 1164 (1943).

As has been pointed out at pp. 499–500, above, this result has been changed by the provision now found in sec. 1016(a)(2) of the 1954 Code. This was first enacted in 1952.

(C) *Real estate transactions.* As the *Crane* case illustrates, sales of real estate present a number of special problems in the tax field. These include such questions as when the transaction is closed, which may affect the year in which the gain or loss is to be reported, and the holding period for the purchaser, as well as questions of basis and adjusted basis. This may be affected by such matters as carrying the transaction out through an escrow agreement, or by the existence of options. Questions may arise as to when and how to report gain or loss, including the effect of the seller's accounting method on such questions, and the nature of the consideration received, whether in a lump sum, or through notes, or simply an agreement to make deferred payments.[1]

I. ALLOCATION OF BASIS

If a man acquires property, and then sells part of it, there would be two possible ways of handling the matter. Either (1) he could apply the amount realized against the basis for the whole of the property, and not return anything as gain until the aggregate amount realized exceeded his basis on the whole, or (2) he could allocate the basis of the whole between the part sold and the part retained in some reasonable manner, and compare the amount realized with the portion of the total basis allocated to the part

[1] These questions are dealt with in detail in Symposium on Tax Problems Encountered in Real Estate Transactions, in 11 Western Reserve L.Rev. 145 (1960); Drye, "The Income Tax Effect of Mortgages," 17 Wash. & Lee L. Rev. 1 (1960); Groh, "Tax Problems in Real Estate," 36 Taxes 267 (1958); Levin, "Capital Gains or Income on Real Estate Sales," 37 B.U.L.Rev. 165 (1957); Young, "The Tax Consequences of Real Estate Financing," 1957 U. of Ill.L.Forum 360; Herzfeld, "Tax Advantages of Partnerships for Property Development," 11 Okla.L.Rev. 393 (1958); Young, "Tax Problems in Real Estate Transactions," 1949 U. of Ill.L.Forum 473; Winsten, "Tax Problems in Real Estate Operations," 20 N.Y. Certified Public Accountant 17 (1950). See also "Effect of Escrow Arrangements on Federal Income Tax Liability," 59 Harv.L.Rev. 1292 (1946); Burford, "Basis of Property after Erroneous Treatment of a Prior Transaction," 12 Tax L.Rev. 365 (1957).

sold. Whenever possible the latter method must be used. Thus if a man buys 100 shares of stock and later sells 50 of them, the basis for the 50 sold is half of the basis on the 100 shares he bought. Or if he buys Blackacre, and later sells a portion of it, the portion sold and the portion retained must be appraised, and the original basis allocated to the two portions in proportion to their value.[2]

Very rarely it is impossible to make such an allocation. That was the situation in the following case.

PIPER v. COMMISSIONER

Tax Court of the United States, 1945. 5 T.C. 1104.

[The taxpayer owned all the stock of X Company, at a cost of $117,757.93. The assets of X were transferred to Y Company, and in exchange Y issued to the taxpayer 80,000 shares of $1 par value common stock, and 57,000 common stock subscription warrants. This was in 1937. In 1940, the taxpayer sold the 57,000 warrants for $28,500. The Tax Court found that: "The warrants had value at the date of their receipt by petitioner but their fair market value at that time was not ascertainable." The Commissioner had ruled that the entire $28,500 was taxable as a capital gain.]

ARUNDELL, JUDGE: The petitioner exchanged his investment in the old company for shares of common stock and common stock subscription warrants in the new company. The exchange was one in which no gain or loss was recognized. No allocation of value was made between the stock and the subscription warrants at the time they were issued to petitioner. Petitioner subsequently sold the warrants in 1940, at 50 cents each, or for a total consideration of $28,500. The respondent takes the view that the warrants had neither fair market value nor actual value at the date of issuance, November 13, 1937, and, consequently, that they had a basis of zero for the purpose of determining gain or loss on the sale or exchange thereof by petitioner. From that position it follows that the petitioner would be taxable upon the sale receipts at the applicable capital gains rate, and that his total investment would be represented by the shares of common stock which he has not disposed of.

The petitioner contends that the warrants had value at the time they were acquired and, while conceding that his allocation of some $37,000 to them was nothing more than his best guess, he argues that such amount is as appropriate as any other amount that could be determined from the facts and cir-

2 Cf. Harlow N. Davock, 20 T.C. 1075 (1953), stated at page 603(B), above.

cumstances. In the alternative he contends that, if no allocation can be made with reasonable certainty, recognition of gain or loss should be deferred until he has recovered his cost.

The Internal Revenue Code does not provide a method for allocating the cost, or other basis for determining gain or loss to each class of securities acquired as a unit. However, the rule has become established that, where a mixed aggregate of assets is acquired in one transaction, the total purchase price shall be fairly apportioned between each class so as to determine profit or loss on subsequent sale of specific assets in the group. If such apportionment be impractical, no profit shall be realized until the cost shall have been recovered out of the proceeds of sales. See *Philip D. C. Ball,* 27 B.T.A. 388, 394; Affd., 69 F.2d 439, without discussion of this point; Mertens, Law of Federal Income Taxation, vol. 3, p. 378. In *H. A. Green,* 33 B.T.A 824, 828, we observed that respondent's regulations had for a number of years provided for such apportionment of cost and for deferment of recognition of gain until cost was recovered where allocation is impractical. It was pointed out that article 1567 of Regulations 62 [1] (interpreting the Revenue Act of 1921) had provided that allocation of cost should be made in proportion to the fair market value of each class of securities at the date of receipt, and that while subsequent regulations do not contain the exact language, the quoted provision lays down a principle equally applicable under subsequent revenue acts. Indeed, under the revenue acts and the Sixteenth Amendment only so much of the proceeds of a sale of property as represents a realized profit over and above the cost of the property sold is taxable as income.

The parties do not question the application of the rule to the instant case, and each of them has set forth the footnoted excerpt from Regulations 103, section 19.22(a)–8,[2] as being applicable.

. . .

We think the respondent erred in attributing the entire cost to the shares of common stock. It can not be said that the warrants had no value simply because they could not be exercised to immediate financial advantage at the time they were issued. The right to subscribe at fixed prices over the prescribed period

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1 Art. 1567. * * * the proportion of the original cost, or other basis, to be allocated to each class of new securities is that proportion which the market value of the particular class bears to the market value of all securities received on the date of the exchange. * * *

2 Sec. 19.22(a)–8. *Sale of stock and rights.*— * * * If common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost.

is the very consideration bargained for by a purchaser, and the fact that they were highly speculative and entirely prospective is no basis, in the circumstances here present, for denying to them any value. *Collin v. Commissioner,* 32 F.2d 753; *Commissioner v. Swenson,* 56 F.2d 544.

Moreover, the petitioner received 80,000 shares of common stock, plus the right to subscribe to 57,000 additional shares at any time during the 4-year period. The result of the transaction was such that petitioner was assured of control of the company, at least during that period and thereafter if he chose to exercise his options under the warrants. There was a question of the future management of the company, as it would affect earnings and dividends. This right of management and control, which was vested in the common stock, was itself valuable, and must have entered into the consideration of the purchaser. *Collin v. Commissioner, supra.* The petitioner testified that he would not have entered into the plan unless it had been possible for him to retain voting control.

The warrants occupied a status different from that of a stock interest. They were not reflected in the capital account of the corporation and did not represent an absolute equitable ownership therein. As emphasized above, their value sprang from the right or privilege of exercising them during a definite period of time and at specific prices to acquire a stock interest. About the only way the fair market value could be measured would be from trading experience with respect to them, that is, sales or bid and asked prices, or from the amount of savings which might have been immediately realizable from their exercise. Evidence given by the only two witnesses was that the warrants had value, but that any value which could have been placed on them at that time would have been entirely speculative. The circumstances here are such that there is no way in which we can ascertain the fair market value of the warrants for purposes of allocating the cost between them and the common stock. Unlike the situation in *Philip D. C. Ball, supra,* the petitioner herein has produced the available and admissible evidence, substantially all of which has been stipulated by the parties.

Does it follow that the respondent must prevail if the petitioner is unable, in view of the circumstances, to establish the fair market value of the warrants at the time of their receipt? We think not. It is clearly established that they were valuable when received and that consideration was paid for them. Moreover, during the period in which they were to run they were quoted from $\frac{3}{4}$ to $3\frac{1}{2}$, and the fact remains that petitioner was able to dispose of his for some $28,000. To deny the petitioner the benefit of the rule in this case would be an injustice, for under that very rule recognition of gain or loss is postponed if

there be no practical basis upon which an allocation can be made. Surely, when it is shown that the warrants had value, even though the measurement thereof be impossible, a determination of no value by the respondent is arbitrary and should be laid aside. See *Helvering v. Taylor,* 293 U.S. 507, and *Miles v. Safe Deposit & Trust Co.,* 259 U.S. 247.

In *Edwin D. Axton,* 32 B.T.A. 613, we pointed out that although one of the stocks in question undoubtedly had some value, a consideration of all of the evidence indicated with reasonable certainty that no figure could be satisfactorily fixed upon to represent its value when received and that under such circumstances the entire cost should be recovered before gain or loss on the transaction was reportable. See also *Kirkland v. Burnet,* 57 F.2d 608; *Sallie Strickland Tricou,* 25 B.T.A. 713; affirmed without discussion of this point, 68 F.2d 280.

There is some question regarding the market value of the common stock at the time it was received. However, in the view we take of the matter that is not now significant. For a proper allocation of cost we would have to determine the market value of both the stock and the warrants. Where there is no market value, as is the situation with respect to the warrants, there is no practical basis upon which an allocation can be made and the taxpayer is entitled to recover his entire original basis before gain or loss will be recognized. *H. A. Green, supra.*

Reviewed by the court.

Decision will be entered under Rule 50.

TURNER and HILL, JJ., dissent.

Notes

(A) In *Inaja Land Co.,* 9 T.C. 727 (1947), it was held that an amount received for an easement over certain land was not directly taxable, but was to be used to reduce the basis of the land.

(B) In *Krahl v. Commissioner,* 9 T.C. 862 (1947), it appeared that the taxpayer owned two adjoining buildings with no connection, except that they had the same heating system. They were bought at different times, and separate records of depreciation and other charges were kept. He sold the two properties to a wholly-owned corporation for an amount which represented his adjusted cost on the two buildings. There was, however, a gain on one and a loss on the other if they were considered separately. It was held that it was a sale of two properties, and that the gain was taxable, the loss not being deductible because of the provision now found in section 267(a).

It may also be necessary to allocate basis over the property received. Thus, a taxpayer may give up a single item of property

and receive several items in a tax free exchange. Sec. 358(b)(1) of the 1954 Code provides that in such a case the basis shall be allocated in accordance with regulations. See sec. 1.358–2 of the Income Tax Regulations. In general, the old basis should be allocated among the new property in proportion to the fair market value of each of the several items of newly received property at the time of receipt. See I.T. 2335, VI–1 Cum.Bull. 18 (1927).

J. HOLDING PERIOD

Sec. 1223 of the 1954 Code

Under sec. 1222 of the Code, some gains and losses are short term; others are long term. The dividing line is fixed at six months. Where there has been no transfer of property, there is ordinarily little difficulty in determining the period during which the property has been held. Where property is acquired in a tax free exchange, it may take as its basis either (1) the basis of property previously held by the taxpayer, and given up on the exchange, or (2) the basis of the property in the hands of the transferor.

In these cases, sec. 1223 provides for "tacking" the old holding period on to the new one.

I.T. 3453

Bureau of Internal Revenue, 1941. 1941–1 Cum. Bull. 254.

Advice is requested whether in determining, under section 117 of the Internal Revenue Code, the period for which property acquired by gift subsequent to December 31, 1920, was held, where the value of the property at the time of the gift is used for the purpose of determining loss in accordance with the provisions of section 113(a)2 of the Internal Revenue Code, such period should be computed from the date of the gift or whether there should be included the period prior thereto for which the property was held by the donor or the last preceding owner by whom it was not acquired by gift.

Section 113(a)2 of the Internal Revenue Code provides in part as follows:

Gifts After December 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower. * * *

Section 117(h)2 of the Code provides:

In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

It will be observed that under section 113(a)2 of the Code, supra, where the fair market value of property at the time of the gift must be used by the donee as the basis for determining the loss sustained from a sale or exchange thereof, the donee does not use the donor's basis of the property under section 113 of the Code, either, in whole or in part, and hence, in determining the period for which the property was held by the donee, the period for which such property was held by the donor or "such other person" should not be included.

It is, accordingly, held that where property was acquired by gift after December 31, 1920, the fair market value of the property at the time of the gift being lower than the basis of such property in the hands of the donor or the last preceding owner by whom it was not acquired by gift, and the property is sold or otherwise disposed of by the donee for an amount less than such fair market value at the time of the gift, the donee will be considered as having held the property from the date of the gift for the purposes of section 117 of the Internal Revenue Code.

Notes

(A) See "Appropriate Holding Period for Capital Gains Tax as Determined on Average Cost Basis," 49 Yale L.J. 938 (1940).

In Rev.Rul. 59–86, 1959–1 Cum.Bull. 209, it was ruled that where a capital asset was acquired by gift, the donee's holding period runs from the date of the gift even though the property is subsequently required to be included in the donor's gross estate as a gift in contemplation of death, so that a new basis was acquired for the property under sec. 1014. The Treasury expressly ruled that the date for determining basis and the date for fixing the commencement of the holding period need not necessarily be the same.

(B) In *Paul v. Commissioner,* 206 F.2d 763 (C.A.3d, 1953), it appeared that the taxpayer bought land and proceeded to build a building on it. The building was partially completed on May 10. He sold the land and building on November 11. It was held that the gain must be allocated, that relating to the land and the part of the building completed by May 10 being long term, while the portion of the gain relating to the part of the building completed after May 10 was short term.

(C) Note that under sec. 1223, the tacking of holding periods is allowed only if the property given up was a capital asset, or

the kind of property to which sec. 1231 applies. (This applies to exchanges after March 1, 1954). This is intended to prevent such a transaction as the transfer of inventory property to a corporation in exchange for its stock, and then immediately selling the stock. Tacking was allowed in such a case in *Commissioner v. Gracey,* 159 F.2d 324 (C.A.5th, 1947). In this way it was possible, before the 1954 Code, to convert an inventory profit into a long term capital gain.

Short Sales and Other Securities Transactions

A considerable amount of manipulation of gains and losses, and converting of short term gains into long term gains, and so on, is possible through use of short sales, puts, calls, and other arrangements. For a consideration of these matters, see Gutkin and Beck, "Taxation of Security Transactions," 7 Rutgers L. Rev. 329 (1953), 31 Taxes 906 (1953); Stone, "How the Capital Gains Tax Affects Buying and Selling Securities," 26 Taxes 1041 (1948); "Federal Taxation of Short Sales of Securities," 56 Harv.L.Rev. 274 (1942); Chapman and Mason, "Recent Legislative Developments in Capital Gains and Losses," 42 Cornell L.Q. 138, 153–160 (1957). See also *Wilmington Trust Co. v. Helvering,* 316 U.S. 164 (1942).

This matter is dealt with in the statute by sec. 1233 of the 1954 Code. This is a complicated provision; but even so it does not appear to cover all of the possible advantages to taxpayers in this area. Under this provision, however, a gain upon the closing of a short sale is treated as a short term gain where the taxpayer held substantially identical property. Thus the manipulations possible through "sales against the box" are eliminated. Until this provision was adopted, in 1950, a man who had a short term capital gain, which he wanted to realize, could retain the stock, but enter into a short sale of a like amount of the same stock. Then when he had held the original stock for more than six months, he could use it to close the short sale. In this way, his short term gain could be converted into a long term gain, without any risk from the fluctuations of the market.

Consider the following plans which are said to be available under the present law:

(1) Suppose a taxpayer has a capital loss which he cannot deduct. He sells short a stock at 80 just before it goes ex-dividend, on a $10 dividend. Immediately after it goes ex-dividend, he covers at 70. He has a gain of $10 on the short sale; but this is not taxed as it is applied against the unused capital loss. He has to pay the $10 dividend, but this is deductible, and thus serves to reduce his income at his top bracket rate.

(2) A taxpayer may have some short term gains. He buys stock in a Regulated Investment Company just before a "capital

gains" distribution. See secs. 851–855 of the 1954 Code. Under sec. 852(b)(3) of the Code this dividend is a long term capital gain to him, no matter how long he has held the stock. Immediately after the capital gain dividend, he sells his shares in the Regulated Investment Company. This produces a short term loss, which can be used to reduce the short term gains he already has. But see sec. 852(b)(4), first enacted in 1958, which makes this device unavailable where the share in the Regulated Investment Company is held for less than 31 days.

(3) Through a short sale "against the box" the taxpayer may shift a short term gain from one year to the next, which may be advantageous to him. Suppose a taxpayer buys X stock on October 1st at 65, and finds it at 90 in December. He does not want a short term gain in that year (as he has no losses to offset it), and wants to carry the gain over. He sells X stock "against the box" short at 90. In the following year he covers the short sale when X stock is 95. He has a short term gain of 30 on the X stock sold, and a short term loss of 5 on the short sale. This is a net short term gain of 25. That is the same as if he had sold in December, but it comes in the following year instead.

"When Issued" Securities. Dealings in prospective issues of securities are sometimes made on a when, as, and if issued basis. Problems arising in the determination of gains and losses on such transactions are dealt with in I.T. 3721, 1945 Cum.Bull. 164, as amended by Rev.Rul. 57–29, 1957–1 Cum.Bull. 519. See also sec. 1233(e)(2)(A) of the 1954 Code.

K. NON-RECOGNITION OF GAIN AND LOSS, AND NON-DEDUCTIBILITY OF LOSSES

Secs. 1031–1036, 267, and 1091 of the 1954 Code, and corresponding provisions of the Income Tax Regulations

There are a considerable number of situations where (1) gains and losses are not recognized, or (2) losses, though recognized, are not deductible. The most frequently encountered examples of the former are specified in secs. 1031–1036, which deal with common non-taxable exchanges. Some of the non-recognized gains and losses relate to corporate reorganizations. These are dealt with more fully in the next Chapter. These provisions are quite complicated, but are of great importance.

"Of a Like Kind"

Under **sec. 1031(a)** of the 1954 Code—as in the earlier law—no gain or loss is recognized when property held for productive use or for investment (not including securities) is exchanged for property "of a like kind." How different may the property be, though, and still be "of a like kind"? The extension for a time went very far in the oil area. But this has now been ended by the final portion of the Supreme Court's decision in the *P. G. Lake, Inc.,* case, set out at p. 572, above.

Problems

(A) Suppose a bank exchanges an apartment house for a vacant lot. Is the gain taxable? See *Harr v. McLaughlin,* 15 F. Supp. 1004 (E.D.Pa.1936). Suppose a department store trades in a delivery truck for a new truck. Is the gain or loss recognized? See sec. 1031(a) and sec. 1.1031(a)-1 of the Income Tax Regulations.

(B) A person buys Blackacre for $5,000. When it is worth $10,000, he transfers it to the X Corporation in exchange for all of the latter's stock. Is the gain recognized? Would a loss be recognized on such an exchange? See sec. 351 of the 1954 Code.

CENTURY ELECTRIC CO. v. COMMISSIONER

United States Court of Appeals, Eighth Circuit, 1951. 192 F.2d 155.

RIDDICK, CIRCUIT JUDGE. The petitioner, Century Electric Company, is a corporation engaged principally in the manufacture and sale of electric motors and generators in St. Louis, Missouri. It is not a dealer in real estate. As of December 1, 1943, petitioner transferred a foundry building owned and used by it in its manufacturing business and the land on which the foundry is situated to William Jewell College and claimed a deductible loss on the transaction in its tax return for the calendar year 1943. The Commissioner of Internal Revenue denied the loss. The Commissioner was affirmed by the Tax Court and this petition for review followed.

The opinion of the Tax Court and its findings of fact, stated in great detail, are reported in 15 T.C. 581. Petitioner accepts the Tax Court's findings of fact as correct.

Since its organization in 1901 petitioner has been continuously successful in business. In its income tax return for the year 1943 it reported gross sales of $17,004,839.73 and gross profits from sales of $5,944,386.93. On December 31, 1942, petitioner owned land, buildings, and improvements of the total depreciated cost of $1,902,552.16. On December 31, 1943, its actual cash on hand amounted to $203,123.70. During the year 1943 it distributed

cash dividends of $226,705.69 and made a contribution to Washington University of $42,500. It also held tax anticipation notes and Series G bonds totaling $2,000,000, readily convertible into cash and sufficient to liquidate its outstanding 1943 tax liability and its two outstanding 90-day bank notes due January 20, 1944.

Petitioner has always operated its business in large part on borrowed capital. In 1943 it had open lines of credit with the Chase National Bank of New York of $300,000, with the Boatmen's National Bank of St. Louis of the same amount, and with the Mercantile-Commerce Bank and Trust Company of $400,000. At the end of 1943 its outstanding loans from the Mercantile bank amounted to $600,000 approved by the authorized officers of the bank. Petitioner has always been able to liquidate its outstanding 90-day bank loans as they become due either by payment or renewal.

The assessed value of petitioner's foundry building and land upon which it is located for 1943 was $205,780. There was evidence that in St. Louis real property is assessed at its actual value. There was also evidence introduced by petitioner before the Tax Court that the market value for unconditional sale of the foundry building, land, and appurtenances was not in excess of $250,000.

As of December 1, 1943, the adjusted cost basis for the foundry building, land, and appurtenances transferred to William Jewell College was $531,710.97. The building was a specially designed foundry situated in a highly desirable industrial location. It is undisputed in the evidence that the foundry property is necessary to the operation of petitioner's profitable business and that petitioner never at any time considered a sale of the foundry property on terms which would deprive petitioner of its use in its business.

Petitioner's explanation of the transaction with the William Jewell College is that in the spring of 1943 a vice-president of the Mercantile bank where petitioner deposited its money and transacted the most of its banking business suggested to petitioner the advisability of selling some of its real estate holdings for the purpose of improving the ratio of its current assets to current liabilities by the receipt of cash on the sale and the possible realization of a loss deductible for tax purposes. Petitioner's operating business was to be protected by an immediate long-term lease of the real property sold.

Petitioner's board of directors rejected this proposition as unsound. But in July 1943, when a vice-president of the Mercantile Bank suggested to petitioner's treasurer that it would be a good idea for petitioner to pay off all its bank loans merely to show that it was able to do so, petitioner interpreted this advice as a call of its bank loans. Acting on this interpretation, petitioner

borrowed from the First National Bank in St. Louis on the security of tax anticipation notes held by it, funds with which it discharged all its bank loans. Immediately thereafter it re-established its lines of bank credit and began consideration of a sale of the foundry property and contemporaneous lease from the purchaser.

On September 2, 1943, petitioner's board of directors adopted a resolution that the executive committee of the board study the situation "and present, if possible, a plan covering the sale and rental back by Century Electric Company of the foundry property." The decision to enter into the transaction described was communicated to the Mercantile bank, but petitioner never publicly offered or advertised its foundry property for sale. The Tax Court found that petitioner "was concerned with getting a friendly landlord to lease the property back to it, as there was never any intention on the part of petitioner to discontinue its foundry operations." Several offers to purchase the foundry property at prices ranging from $110,000 to $150,000 were received and rejected by petitioner.

At a special meeting of the board of directors of petitioner on December 9, 1943, the president of petitioner reported that the offices of petitioner had entered into negotiations for the sale of the foundry property to William Jewell College for the price of $150,000 with the agreement of said college; "that in addition thereto said Trustees of William Jewell College further have agreed to execute a lease of the property so purchased to Century Electric Company for the same time and on substantially the same terms and conditions which were authorized to be accepted by the special meeting of shareholders of this corporation, held on the 24th day of November, 1943." The stockholders at the November meeting had authorized the sale of the foundry property at not less than $150,000 cash, conditioned upon the purchaser executing its lease of the property sold for a term of not less than 25 and not more than 95 years. The Board by resolution approved the proposed transaction with the William Jewell College, but on condition that "this corporation will acquire from Trustees of William Jewell College, a Missouri Corporation, an Indenture of Lease * * * for a term of not less than twenty-five years and for not more than ninety-five years." The resolution set out in detail the terms of the lease from the college to petitioner, approved the form of the deed from the petitioner to the college, authorized the president and secretary of petitioner to execute the lease after its execution by the trustees of the college, and directed "that the president and secretary of this corporation be authorized to deliver said Warranty Deed to said purchaser upon receiving from said purchaser $150,000 in cash, and upon receiving from said purchaser duplicate executed In-

denture of Lease on the forms exhibited to this Board." The resolution provided that the deed and lease should be dated December 1, 1943, and effective as of that date.

The deed and the lease were executed and delivered as provided by the resolution of petitioner's board of directors. Neither instrument referred to the other. The deed was in form a general warranty deed, reciting only the consideration of $150,000 in cash. The lease recited among others the respective covenants of the parties as to its term, its termination by either the lessor or lessee, and as to the rents reserved.

As of December 31, 1942, the ratio of petitioner's current assets to its current liabilities was 1.74. The $150,000 in cash received by petitioner on the transaction increased the ratio of current assets to current liabilities from 1.74 to 1.80. The loss deduction which petitioner claims on the transaction and its consequent tax savings would if allowed have increased the ratio approximately twice as much as the receipt of the $150,000.

The questions presented are:

1. Whether the transaction stated was for tax purposes a sale of the foundry property within the meaning of section 112 of the Internal Revenue Code, on which petitioner realized in 1943 a deductible loss of $381,710.97 determined under section 111 of the code (the adjusted basis of the foundry property of $531,-710.97 less $150,000) as petitioner contends; or, as the Tax Court held, an exchange of property held for productive use in a trade or business for property of a like kind to be held for productive use in trade or business in which no gain or loss is recognized under sections 112(b)(1)[1] and 112(e),[2] and Regulation 111, section 29.112(b)(1)-1.[3]

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[1] "Sec. 112. Recognition of Gain or Loss.

"(b) Exchanges solely in kind. (1) Property held for productive use or investment. No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, or stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

[2] "(e) Loss from exchanges not solely in kind. If an exchange would be within the provisions of subsection (b)(1) to (5), inclusive, or (10), or within the provisions of subsection (*l*), of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized."

[3] "Sec. 29.112(b)(1)-1. Property Held for Productive Use in Trade or Business or for Investment.—As used in section 112(b)(1), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material,

2. Whether if the claimed loss deduction is denied, its amount is deductible as depreciation over the 95-year term of the lease as the Tax Court held, or over the remaining life of the improvements on the foundry as the petitioner contends.

On the first question the Tax Court reached the right result. The answer to the question is not to be found by a resort to the dictionary for the meaning of the words "sales" and "exchanges" in other contexts, but in the purpose and policy of the revenue act as expressed in section 112. Compare *Federal Deposit Insurance Corp. v. Tremaine,* 2 Cir., 133 F.2d 827, 830; *Cabell v. Markham,* 2 Cir., 148 F.2d 737, 739; *Markham v. Cabell,* 326 U.S. 404, 409; *Brooklyn National Corp. v. Commissioner,* 2 Cir., 157 F.2d 450, 451; *Emery v. Commissioner,* 2 Cir., 166 F.2d 27, 30. In this section Congress was not defining the words "sales" and "exchanges". It was concerned with the administrative problem involved in the computation of gain or loss in transactions of the character with which the section deals. Subsections 112(b)(1) and 112(e) indicate the controlling policy and purpose of the section, that is, the non-recognition of gain or loss in transactions where neither is readily measured in terms of money, where in theory the taxpayer may have realized gain or loss but where in fact his economic situation is the same after as it was before the transaction. See *Fairfield S. S. Corp. v. Commissioner,* 2 Cir., 157 F.2d 321, 323; *Trenton Cotton Oil Co. v. Commissioner,* 6 Cir., 147 F.2d 33, 36. For tax purposes the question is whether the transaction falls within the category just defined. If it does, it is for tax purposes an exchange and not a sale. So much is indicated by subsection 112(b)(1) with regard to the exchange of securities of readily ascertainable market value measured in terms of money. Gain or loss on exchanges of the excepted securities is recognized. Under subsection 112(e) no loss is recognized on an exchange of property held for productive use in trade or business for like property to be held for the same use, although other property or money is also received by the taxpayer. Compare this subsection with subsection 112(c)(1) where in the same circumstances gain is recognized but only to the extent of the other property or money received in the transaction. The comparison clearly indicates that in the computation of gain or loss on a transfer of property held for productive use in trade or business for property of a like kind to be held for the same use, the market value of the properties of like kind involved in the transfer does not enter into the equation.

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for such fact relates only to the grade or quality of the property and not to its kind or class. * * *

"No gain or loss is recognized if * * * (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate. * * *."

The transaction here involved may not be separated into its component parts for tax purposes. Tax consequences must depend on what actually was intended and accomplished rather than on the separate steps taken to reach the desired end. The end of the transaction between the petitioner and the college was that intended by the petitioner at its beginning, namely, the transfer of the fee in the foundry property for the 95-year lease on the same property and $150,000.

It is undisputed that the foundry property before the transaction was held by petitioner for productive use in petitioner's business. After the transaction the same property was held by the petitioner for the same use in the same business. Both before and after the transaction the property was necessary to the continued operation of petitioner's business. The only change wrought by the transaction was in the estate or interest of petitioner in the foundry property. In Regulations 111, section 29.–112(b)(1)–1, the Treasury has interpreted the words "like kind" as used in subsection 112(b)(1). Under the Treasury interpretation a lease with 30 years or more to run and real estate are properties of "like kind." With the controlling purpose of the applicable section of the revenue code in mind, we can not say that the words "like kind" are so definite and certain that interpretation is neither required nor permitted. The regulation, in force for many years, has survived successive reenactments of the internal revenue acts and has thus acquired the force of law. *United States v. Dakota-Montana Oil Co.*, 288 U.S. 459, 466; *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U.S. 110, 116; and see *Commissioner of Internal Revenue v. Crichton*, 5 Cir., 122 F.2d 181.

On the second question the Tax Court held that petitioner was not entitled to depreciation on the improvements on the foundry property over their useful life after December 1, 1943. The answer to this question depends upon whether as a result of the transaction under consideration the petitioner has an identifiable capital investment in the improvements on the land covered by the lease. Petitioner contends that the amount of its claimed loss, $381,710.97, should be apportioned between the land and improvements in proportion to their respective cost bases as of November 30, 1943. This would result in an allocation of $277,-076.68 of petitioner's investment in the leasehold to the improvements and $104,634.29 to the land. The difficulty with petitioner's position is that it involves assumptions and inferences which find no support in the record. What the petitioner has done is to exchange the foundry property having an adjusted basis of $531,710.97 on December 1, 1943, for a leasehold and $150,000 in cash. Its capital investment is in the leasehold and not its constituent properties. Accordingly, we agree with the

Tax Court that petitioner is entitled to depreciation on the leasehold. The basis for depreciation of the leasehold on December 1, 1943, is therefore, $381,710.97 under section 113(a)(6) of the revenue code, deductible over the term of the lease.

The decision of the Tax Court is affirmed.

Notes

(A) But in *Jordan Marsh Co. v. Commissioner,* 269 F.2d 453 (C.A.2d, 1959), the court held, in a very similar sale and lease-back situation, that the *Century Electric* decision was not applicable. In the *Jordan Marsh* case, there were findings that the sale was for the full fair market value of the property, and the rentals under the leases "were full and normal rentals so that the leasehold interests which devolved upon the petitioner were of no capital value." The court held that there was no "exchange" in the *Jordan Marsh* case, but a sale, and the loss on the sale was allowed. See comments in 5 Villanova L.Rev. 314 (1960), and 73 Harv.L.Rev. 1621 (1960).

The Treasury has announced that it will not follow the *Jordan Marsh* case. Rev.Rul. 60–43, 1960–1 Cum.Bull. ——.

(B) See generally, Cary, "Corporate Financing through the Sale and Lease-Back of Property: Business, Tax and Policy Considerations," 62 Harv.L.Rev. 1 (1948); Greenfield, "Corporate Benefits in Using the Sale-Leaseback Device," 37 Taxes 1017 (1959).

Involuntary Conversion

Special provisions are included in the Code for non-recognition of gain in cases of involuntary conversion, as where property is taken on eminent domain, or destroyed by fire. These are applicable only where the taxpayer makes arrangements to use the proceeds to acquire "property similar or related in service or use to the property so converted." See **sec. 1033** of the 1954 Code. (The corresponding provision of the prior law was sec. 112(f) of the 1939 Code.) Note how this provision fits in with sec. 1231. There are also similar special provisions with respect to the sale of radio stations under orders from the Federal Communications Commission (sec. 1071), with respect to transfers made pursuant to orders of the Securities and Exchange Commission (sec. 1081), and with respect to the involuntary liquidation of inventories due to inability to get replacements. See sec. 1321 of the 1954 Code.

HARRY G. MASSER

Tax Court of the United States, 1958. 30 T.C. 741.

KERN, JUDGE. The question presented by this case is whether section 112(f)(1) of the Internal Revenue Code of 1939[1] is applicable to the facts here before us. Those facts may be summarized as follows: Petitioner, who operated an interstate trucking business, bought at one time two pieces of property situated across a street from each other, one improved by a building (including offices and a bunkhouse) to be used for the loading and unloading of trucks, and the other to be used as space in which the trucks could be parked pending their loading and unloading. The two pieces of property were used together as an economic unit, constituting petitioner's terminal facilities serving the New York metropolitan area. It is conceded that the parking area was "involuntarily converted" by petitioner as the result of the threat or imminence of condemnation. If petitioner retained the improved property, the closest available space for a parking area would have been approximately a mile and a half away. For petitioner to have operated his truck terminal with his parking area that far from the building where the loading and unloading of his trucks took place and where his offices were located would have been physically possible, but would have been economically impractical because (1) it would have entailed considerable direct expense in connection with the additional labor required, (2) it would have resulted in increasing the hazards of traffic accidents and cargo thefts, (3) it would have resulted in such delays in deliveries as to have affected adversely petitioner's customer relations, and (4) it would have presented complicated problems in connection with traffic management. Because of the involuntary sale of the parking area as a result of the threat of condemnation, petitioner decided in good faith and in the exercise of prudent business judgment to sell the improved property also and to use the proceeds of both properties to buy property in the same general locality suitable for similar use as a truck terminal. Under these circumstances, was the sale of the improved property an involuntary conversion as a result of the threat or imminence of condemnation?

We are not aware of any authorities directly in point as to the question presented, and the legislative history of section 112(f) and its predecessor sections is not helpful.

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1 Sec. 112. Recognition of Gain or Loss.

(f) Involuntary Conversion.—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) Conversion into similar property.—Into property similar or related in service or use to the property so converted, no gain shall be recognized.

Bearing in mind two basic principles, that "[t]axation * * * is eminently practical," *Tyler v. United States,* 281 U.S. 497, 503, and that a relief provision "should be liberally construed to effectuate its purpose," *Massillon-Cleveland-Akron Sign Co.,* 15 T.C. 79, 83, we are of the opinion that when two pieces of property, practically adjacent to each other, were acquired for the purpose of being used and were used in a taxpayer's business as an economic unit, when one of the pieces of property was involuntarily sold as a result of the threat of condemnation, when it was apparent that the continuation of the business on the remaining piece of property was impractical, and as a result of the involuntary sale of the one piece of property the taxpayer in the exercise of good business judgment sold the other piece of property, and when the proceeds of both sales were expended in the acquisition of property similar to the economic unit consisting of the two properties sold, the transaction, considered as a whole, constitutes an involuntary conversion of one economic property unit within the meaning of section 112(f).

Decision will be entered for petitioners.

Notes

(A) The Commissioner has acquiesced in this decision. 1959–2 Cum.Bull. 5. See also Rev.Rul. 59–361, 1959–2 Cum.Bull. 183, where his position to this effect is further expressed.

(B) A state "deadlock" statute provides for the dissolution of a corporation under the supervision of a court of equity when the board of directors is equally divided and unable to function. A decree for dissolution was entered, and each group of the shareholders bid for the others' shares. As a result T sold his shares, and then reinvested the proceeds in shares of another company engaged in a similar business. Was this an "involuntary conversion" within the meaning of sec. 1033? A negative answer was given in *Dear Publication & Radio, Inc. v. Commissioner,* 274 F.2d 656 (C.A.3d, 1960).

(C) For discussions of problems under this provision, see Groh, "Involuntary Conversion and Casualty Losses," 35 Taxes 589 (1957); Seghers, "Federal Income Tax Problems—Fire and Casualty Insurance," 35 Taxes 713 (1957); Miller, "Land Condemnations—Federal Income Tax Consequences," 38 Neb.L.Rev. 507 (1959); "An Executor's Reinvestment in Accordance with Section 112(f) of the Internal Revenue Code," 53 Col.L.Rev. 563 (1953); Brown, "The Replacement Fund in Involuntary Conversion," 28 Taxes 137 (1951).

(D) Section 1033 of the 1954 Code carries forward a provision first enacted in 1954 under which a replacement made *before* the property is actually taken may be effective in avoiding gain on the conversion.

Sale or Exchange of Taxpayer's Residence

The provision now found in **sec. 1034** of the 1954 Code was first added to the statute in 1951. It provides for non-recognition of gain on the sale of a personal residence, when the proceeds are reinvested in a new residence within one year before or after the old residence is sold.

Note

This provision is fairly simple in purpose and effect. It is probably a desirable one, although it may mean that practically all gains with respect to personal residences will wholly escape taxation. It is not enough to say that the tax is merely postponed, because the income tax on accumulated gains will be passed by on the death of the taxpayer—since sec. 1014 gives the recipient then the basis at the date of the taxpayer's death.

Although the provision is fairly simple in purpose and effect, it is interesting to note that a fairly elaborate provision is required to carry it into operation. The provisions of sec. 1034 should be carefully examined simply as an exercise in statutory draftsmanship, and an illustration of the problems which must be resolved in developing any new provision in the law of this sort.

"Boot"

Note the provisions of **sec. 1031(b)** relating to exchanges not solely in kind. See also the similar provisions in sec. 356 with respect to property received in corporate reorganizations. These are the so-called "boot" provisions. They prescribe the rule to be followed where the exchange is not tax-free because "boot"—either money, or some other property—is received, in addition to the property which might be received tax-free. (The word "tax-free" is often, though loosely, applied to a situation where either a gain or a loss is not recognized.) The language of secs. 1031(b) and 356 may appear complicated, but it is not too difficult if it is followed through step by step.

Problems

(A) A owns Blackacre, which he holds for investment. Its cost (and basis) was $10,000. A trades Blackacre to B, and receives in exchange Whiteacre and $5,000 in cash. The fair market value of Whiteacre at the time of the exchange is $8,000. Does A have a recognized gain or loss, and if so, how much?

Suppose that the facts are the same, except that the fair market value of Whiteacre is $1,000. What result? Suppose the fair market value of Whiteacre is $11,000. What result?

(B) *Basis.* What is the basis of Whiteacre in each of the above instances? See sec. 1031(d) of the 1954 Code. Cf. sec. 358.

(C) Here is a fairly hard one. See if you can do it. It involves just about everything. The only way to handle it is to follow it step by step through the statute.

A farmer has a cow, Bossy. His basis for Bossy is $100. He trades Bossy for another cow, Bessy, and for Bessy's calf, Betty. The fair market value of Bessy is $125; that of Betty is $25. In addition, the farmer receives as boot $25 in cash, and a radio for his home having a fair market value of $25. Thus he receives altogether four items of property having an aggregate value of $200.

What is the amount of the farmer's gain? How much of the gain is recognized? What is the farmer's basis for the several items of property received? As to all questions, under what provisions of the statute?

Some losses, though recognized, are not deductible. The provisions leading to this result are secs. 267 and 1091 which should be carefully examined. Reference has already been made to sec. 267 at pp. 436–437, above. The provision now found in sec. 267 is involved in the following case.

McWILLIAMS v. COMMISSIONER

Supreme Court of the United States, 1947. 331 U.S. 694.

MR. CHIEF JUSTICE VINSON delivered the opinion of the Court.

The facts of these cases are not in dispute. John P. McWilliams, petitioner in No. 945, had for a number of years managed the large independent estate of his wife, petitioner in No. 947, as well as his own. On several occasions in 1940 and 1941 he ordered his broker to sell certain stock for the account of one of the two, and to buy the same number of shares of the same stock for the other, at as nearly the same price as possible. He told the broker that his purpose was to establish tax losses. On each occasion the sale and purchase were promptly negotiated through the Stock Exchange, and the identity of the persons buying from the selling spouse and of the persons selling to the buying spouse was never known. Invariably, however, the buying spouse received stock certificates different from those which the other had sold. Petitioners filed separate income tax returns for these years, and claimed the losses which he or she sustained on the sales as deductions from gross income.

The Commissioner disallowed these deductions on the authority of § 24(b) of the Internal Revenue Code,[1] which prohibits

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1 The material parts of § 24(b) are as follows:

"(b) *Losses from sales or exchanges of property.*

"(1) *Losses disallowed.* In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—

"(A) Between members of a family, as defined in paragraph (2)(D);

"(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

deductions for losses from "sales or exchanges of property, directly or indirectly . . . between members of a family," and between certain other closely related individuals and corporations.

On the taxpayers' applications to the Tax Court, it held § 24 (b) inapplicable, following its own decision in *Ickelheimer v. Commissioner*,[2] and expunged the Commissioner's deficiency assessments.[3] The Circuit Court of Appeals reversed the Tax Court [4] and we granted certiorari because of a conflict between circuits and the importance of the question involved.

Petitioners contend that Congress could not have intended to disallow losses on transactions like those described above, which, having been made through a public market, were undoubtedly bona fide sales, both in the sense that title to property was actually transferred, and also in the sense that a fair consideration was paid in exchange. They contend that the disallowance of such losses would amount, *pro tanto,* to treating husband and wife as a single individual for tax purposes.

In support of this contention, they call our attention to the pre-1934 rule, which applied to all sales regardless of the relationship of seller and buyer, and made the deductibility of the resultant loss turn on the "good faith" of the sale, *i. e.,* whether the seller actually parted with title and control. They point out that in the case of the usual intra-family sale, the evidence material to this issue was peculiarly within the knowledge and even the control of the taxpayer and those amenable to his wishes, and inaccessible to the Government. They maintain that the only purpose of the provisions of the 1934 and 1937 Revenue Acts—the forerunners of § 24(b) [5]—was to overcome

"(C) Except in the case of distributions in liquidation, between two corporations more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

"(D) Between a grantor and a fiduciary of any trust;

"(E) Between the fiduciary of a trust and the fiduciary of another trust, if the same person is a grantor with respect to each trust; or

"(F) Between a fiduciary of a trust and a beneficiary of such trust."

Section 24(b)(2)(D) defines the family of an individual to include "only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; . . ."

2 45 B.T.A. 478, affirmed, 132 F.2d 660 (C.C.A. 2).

3 5 T.C. 623.

4 158 F.2d 637 (C.C.A. 6).

5 The provisions of § 24(b)(1)(A) and (B) of the Internal Revenue Code originated in § 24(a)(6) of the Revenue Act of 1934, 48 Stat. 680, 691. These provisions were reenacted without change as § 24(a)(6) of the Revenue Act of 1936, 49 Stat. 1648, 1662, and the provisions of § 24(b)(1)(C), (D), (E), and (F) of the Code were added by § 301 of the 1937 Act, 50 Stat. 813, 827.

these evidentiary difficulties by disallowing losses on such sales irrespective of good faith. It seems to be petitioners' belief that the evidentiary difficulties so contemplated were only those relating to proof of the parties' observance of the formalities of a sale and of the fairness of the price, and consequently that the legislative remedy applied only to sales made immediately from one member of a family to another, or mediately through a controlled intermediary.

We are not persuaded that Congress had so limited an appreciation of this type of tax avoidance problem. Even assuming that the problem was thought to arise solely out of the taxpayer's inherent advantage in a contest concerning the good or bad faith of an intra-family sale, deception could obviously be practiced by a buying spouse's agreement or tacit readiness to hold the property sold at the disposal of a selling spouse, rather more easily than by a pretense of a sale where none actually occurred, or by an unfair price. The difficulty of determining the finality of an intra-family transfer was one with which the courts wrestled under the pre-1934 law, and which Congress undoubtedly meant to overcome by enacting the provisions of § 24(b).

It is clear, however, that this difficulty is one which arises out of the close relationship of the parties, and would be met whenever, by prearrangement, one spouse sells and another buys the same property at a common price, regardless of the mechanics of the transaction. Indeed, if the property is fungible, the possibility that a sale and purchase may be rendered nugatory by the buying spouse's agreement to hold for the benefit of the selling spouse, and the difficulty of proving that fact against the taxpayer, are equally great when the units of the property which the one buys are not the identical units which the other sells.

Securities transactions have been the most common vehicle for the creation of intra-family losses. Even if we should accept petitioners' premise that the only purpose of § 24(b) was to meet an evidentiary problem, we could agree that Congress did not mean to reach the transactions in this case only if we thought it completely indifferent to the effectuality of its solution.

Moreover, we think the evidentiary problem was not the only one which Congress intended to meet. Section 24(b) states an absolute prohibition—not a presumption—against the allowance of losses on any sales between the members of certain designated groups. The one common characteristic of these groups is that their members, although distinct legal entities, generally have a near-identity of economic interests. It is a fair inference that even legally genuine intra-group transfers were not thought to result, usually, in economically genuine realizations of loss, and accordingly that Congress did not deem them to be appropriate occasions for the allowance of deductions.

The pertinent legislative history lends support to this inference. The Congressional Committees, in reporting the provisions enacted in 1934, merely stated that "the practice of creating losses through transactions between members of a family and close corporations has been frequently utilized for avoiding the income tax," and that these provisions were proposed to "deny losses to be taken in the case of [such] sales" and "to close this loophole of tax avoidance." [6] Similar language was used in reporting the 1937 provisions.[7] Chairman Doughton of the Ways and Means Committee, in explaining the 1937 provisions to the House, spoke of "the artificial taking and establishment of losses where property was shuffled back and forth between various legal entities owned by the same persons or person," and stated that "these transactions seem to occur at moments remarkably opportune to the real party in interest in reducing his tax liability but, at the same time allowing him to keep substantial control of the assets being traded or exchanged." [8]

We conclude that the purpose of § 24(b) was to put an end to the right of taxpayers to choose, by intra-family transfers and other designated devices, their own time for realizing tax losses on investments which, for most practical purposes, are continued uninterrupted.

We are clear as to this purpose, too, that its effectuation obviously had to be made independent of the manner in which an intra-group transfer was accomplished. Congress, with such purpose in mind, could not have intended to include within the scope of § 24(b) only simple transfers made directly or through a dummy, or to exclude transfers of securities effected through the medium of the Stock Exchange, unless it wanted to leave a loop-hole almost as large as the one it had set out to close.

Petitioners suggest that Congress, if it truly intended to isallow losses on intra-family transactions through the market, would probably have done so by an amendment to the wash sales provisions,[9] making them applicable where the seller and buyer

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6 H.Rep.No.704, 73d Cong., 2d Sess., p. 23 (1939–1 Cum.Bull. (Part 2) 554, 571): S.Rep.No.558, 73d Cong., 2d Sess., p. 27 (1939–1 Cum.Bull. (Part 2) 586, 607).

7 The type of situations to which these provisions applied was described as being that "in which due to family relationships or friendly control, artificial losses might be created for tax purposes." H.Rep.No.1546, 75th Cong., 1st Sess., p. 28 (1939–1 Cum.Bull. (Part 2) 704, 724).

8 81 Cong.Rec. 9019. Representative Hill, chairman of a House subcommittee on the income-tax laws, explained to the House with reference to the 1934 provisions that the Committee had "provided in this bill that transfers between members of the family for the purposes of creating a loss to be offset against ordinary income shall not be recognized for such deduction purposes." 78 Cong.Rec. 2662.

9 Sec. 118 of the Internal Revenue Code, which first appeared in its present form as § 118 of the Revenue Act of 1932, 47 Stat. 169, 208, provides in part as follows:

were members of the same family, as well as where they were one and the same individual. This extension of the wash sales provisions, however, would bar only one particular means of accomplishing the evil at which § 24(b) was aimed, and the necessity for a comprehensive remedy would have remained. . . .

Petitioners also urge that, whatever may have been Congress' intent, its designation in § 24(b) of sales "between" members of a family is not adequate to comprehend the transactions in this case, which consisted only of a sale of stock by one of the petitioners to an unknown stranger, and the purchase of different certificates of stock by the other petitioner, presumably from another stranger.

We can understand how this phraseology, if construed literally and out of context, might be thought to mean only direct intra-family transfers. But petitioners concede that the express statutory reference to sales made "directly or indirectly" precludes that construction. Moreover, we can discover in this language no implication whatsoever that an indirect intra-family sale of fungibles is outside the statute unless the units sold by one spouse and those bought by the other are identical. Indeed, if we accepted petitioners' construction of the statute, we think we would be reading into it a crippling exception which is not there. . . .

Affirmed.

Problem and Notes

(A) The provisions now found in sec. 267 of the 1954 Code originated in 1934, but were enlarged by the Revenue Act of 1937. See Paul, "The Background of the Revenue Act of 1937," 5 U. of Chi.L.Rev. 41, 69–71 (1937); "Nondeductible Capital Losses and Bona Fide Sales Under the Federal Income Tax," 49 Yale L.J. 75 (1939); Moore, "When Is a Sale Not a Sale? 25 Taxes 326 (1947); Stapleton, "Losses Between Related Taxpayers Under Section 24(b)," 31 Taxes 902 (1953); Gillian, "Some Effects of Nonrecognized Losses on Corporations and Their Shareholders," 35 N.C.L.Rev. 31 (1956).

Where property was sold by an estate to a trust of which the estate's decedent was grantor, it has been ruled that the loss is deductible. Rev.Rul. 56–222, 1956–1 Cum.Bull. 155.

"§ 118. *Loss from wash sales of stock or securities.*

"(a) In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction for the loss shall be allowed under section 23(e)(2); nor shall such deduction be allowed under section 23(f) unless the claim is made by a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of its business."

(B) A man bought 100 shares of stock at $10 a share. Later he bought 100 more shares at $40 a share, making the total cost $5,000. Thereafter, he sold these 200 shares to his brother at $20 a share, or a total of $4,000. What are the tax consequences? See *Lakeside Irrigation Co. v. Commissioner*, 128 F.2d 418 (C.C.A.5th, 1942), noted in 56 Harv.L.Rev. 136 (1942); *M. F. Reddington Co. v. Commissioner*, 131 F.2d 1014 (C.C.A.2d, 1942); *Morris Investment Corp. v. Commissioner*, 156 F.2d 748 (C.C.A.3rd, 1946), cert. den., 329 U.S. 788 (1946).

(C) This matter is to some extent taken care of by the provision in sec. 267(d), which is new in the 1954 Code. Until then, if a loss was dissallowed under this provision, it was gone for good. Now it can be utilized, but by the transferee rather than by the transferor, and only to offset gain thereafter derived by the transferee. Note that this rule reduces the amount of an eventual taxable gain, but it does not affect the basis for determining gain, so that such items as depreciation on the property will be determined on the basis of the amount actually paid by the transferee. Similarly, if the transferee gives the property away, the donee takes the transferee's basis, and is not entitled to the benefits of sec. 267(d).

(D) The Supreme Court held that a loss could not be deducted on a sale to a wholly owned corporation even under the Revenue Act of 1932, which contained no provision dealing with this problem. *Higgins v. Smith*, 308 U.S. 473 (1940). Query whether this result would have been reached at an earlier date. In *Burnet v. Commonwealth Improvement Co.*, 287 U.S. 415 (1933), the Court held that a corporation was taxable on a gain derived from a sale to its sole stockholder.

Wash Sales

Another provision disallowing the deduction of a loss is found in sec. 1091 of the 1954 Code, relating to wash sales. This was formerly in sec. 118 of the 1939 Code, and has been in the statute since 1921.

This provision applies only to losses. There is no restriction on the recognition of a gain, even though property similar to that sold is bought back immediately. See I.T. 1239, I–1 Cum.Bull. 149 (1922). Thus, a taxpayer who has capital losses which he cannot deduct may have assets which he can sell at a gain. This gain can be taken without tax liability since it will be offset by the losses already realized. If he makes the sale at a gain, and buys back similar property immediately, the property purchased will have an increased basis which may reduce the tax in the case of a future sale.

Section 1091 applies only where the taxpayer purchases "substantially identical stocks or securities." Are municipal bonds of the same debtor but with different maturities "substantially identical"—or bonds of different Federal Land Banks with almost the same maturity date? See *Hanlin v. Commissioner*, 108 F.2d 429 (C.C.A.3d, 1939); Rev.Rul. 60–195, 1960–1 Cum.Bull. ——.

Loss on sale of personal residence

Reference has already been made (at p. 389, above) to the fact that a *loss* on the sale of a personal residence is not deductible, since it is regarded as a "personal, living or family" expense. Consider the following ruling:

In 1927, the taxpayer bought a tract of 245 acres for $25,000, and built a large residence on it, costing $425,000. He used it as his personal and family residence. In 1952, he tried to sell the whole property, but was unsuccessful. In 1954 he sold 50 acres of the property, containing the residence and all the improvements, for $175,000. Later in the same year, he sold the remaining acreage to a different purchaser in a separate transaction, for $380,000. The Treasury ruled that the sale of each parcel was a separate transaction, with gain and loss computed separately on each. The gain was taxable, and the loss on the sale of the 50 acre tract including the residence was not deductible. Rev.Rul. 54–95, 1954–1 Cum.Bull. 98.

CHAPTER 9

CORPORATE DISTRIBUTIONS AND REORGANIZATIONS

Secs. 301–394 of the 1954 Code, and the Corresponding provisions of the Income Tax Regulations

The taxability of distributions by a corporation is the subject matter of secs. 301–364 of the 1954 Code, which should be carefully examined in connection with this Chapter. (The same subject matter was formerly covered by the several subdivisions of sec. 115 of the 1939 Code.) For clear and careful consideration of many of the problems in this Chapter, see Bittker, Federal Income Taxation of Corporations and Shareholders (1959).[1]

Corporate distributions fall into several classes for tax purposes:

(1) Dividends are distributions out of "earnings and profits." Sec. 316 of the 1954 Code. There must be "earnings and profits," and that makes it necessary to determine what the phrase "earnings and profits" means.[2] A number of aspects of this term are defined in the statute (see, for example, sec. 312 of the 1954 Code) but there is no general or comprehensive definition of the term.

(2) Corporate distributions which are not dividends because there are no earnings and profits. These are governed by sec. 301(c)(1) and (2).

(3) Distributions or payments in connection with the redemption of stock. Under secs. 302 and 304 these may be taxable as dividends. See also sec. 303.

(4) Distributions in partial or total liquidation. These are governed by secs. 331–346, and may occur whether there are or are not earnings and profits.

(5) Distributions in stock of the declaring corporation, or stock dividends. The applicable provision here is sec. 305. See also secs. 306–307.

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[1] See also Dean and Headley, "New Corporate Concepts under the 1954 Revenue Code," 103 U. of Pa.L.Rev. 491 (1955); Bittker, "Corporate Dividends and Other Non-Liquidating Distributions in Cash, Stock, and Obligations," 5 Howard L.J. 46 (1959).

[2] The phrases "earnings and profits" and "earnings or profits" have been used interchangeably in earlier statutes, and elsewhere. In the 1954 Code, the phrasing appears to be "earnings and profits" consistently. Both forms of the phrase mean the same thing, and each is a single concept. There is no special emphasis to be put on "earnings" or "profits." Each of those words may have a meaning, but "earnings and profits" or "earnings or profits" is a special term of art in the tax law.

(6) Distributions in connection with a corporate reorganization. These may be wholly or partially tax-free under secs. 351, 354, and 355 and the corresponding provision of sec. 368, which defines a "reorganization."

Under the present income tax law, corporate income is insulated from the shareholder. Ordinarily, the shareholder is taxed only on distributions of one sort or another which come to him; he is not taxed on the income derived by the corporation. In this respect, the tax with respect to corporations is in sharp contrast with the tax as applied to partnerships. Under our law, partnerships are not taxpayers. They are merely conduits. Partnership income is taxed directly to the partners, whether it is distributed or not. See secs. 701–771 of the 1954 Code, especially sec. 702.

In the Civil War income tax law, corporate income was taxed as we now tax partnership income, that is, the "gains and profits of all companies" was included in "the annual gains, profits, or income of any person, entitled to the same, whether divided or otherwise." In *Collector v. Hubbard,* 12 Wallace 1 (1870), this was held valid and effective. Would it be feasible to apply the rule of *Collector v. Hubbard* generally today?

Does Congress today have power to tax corporate income directly to the shareholders? See Powell, "The Stock Dividend Decision and the Corporate Nonentity," 5 Bull.Nat.Tax Ass'n 201 (1920). In this connection attention should be given to the provisions of secs. 551–557 of the 1954 Code, relating to foreign personal holding corporations. Under sec. 551(a), the undistributed income of a foreign personal holding corporation is taxed directly to United States shareholders.[3] Reference may also be made to sec. 220 of the Revenue Act of 1918, and corresponding provisions of earlier Acts. These were the forerunners of the present secs. 531–537 of the 1954 Code, and they attempted to get at unreasonable accumulations by corporations by taxing them directly to the shareholders.

At various times, the tax laws have included a number of optional provisions under which shareholders could elect to be taxable directly on the corporate income, as if the organization were a partnership. See sec. 218(e) of the Revenue Act of 1918, and secs. 391–396 of the 1939 Code, relating to personal service corporations. This is now allowed for certain "small business corporations" by Subchapter S, secs. 1371–1377, of the 1954 Code, first enacted in 1958. See also the provisions of sec. 565 of the 1954 Code, relating to "Consent Dividends." Sec. 1361 of the

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[3] See Krichman, "Are U. S. Shareholders Taxable for the Undistributed Income of Foreign Personal Holding Companies?" 16 Tax Mag. 712 (1938); Brewster, "Is the Undistributed Income of Foreign Personal Holding Companies Taxable to United States Stockholders?" 16 Tax Mag. 69 (1938).

1954 Code also has a converse provision, under which certain proprietorships and partnerships may elect to be taxed as corporations.

A. DIVIDENDS

Sec. 316 of the 1954 Code

REGENSBURG v. COMMISSIONER

United States Circuit Court of Appeals, Second Circuit, 1944. 144 F.2d 41.

SWAN, CIRCUIT JUDGE. These proceedings involve the income tax liability for the years 1936 to 1940, inclusive, of four brothers, Mortimer, Isaac, Melville and Jerome Regensburg, who were the principal shareholders of E. Regensburg & Sons, a New York corporation, during the tax years in suit. Jerome Regensburg died on October 31, 1941 and his estate is represented by his executrix. Sophy P. Regensburg is the wife of Melville, with whom she filed a joint return for the year 1940, and she joins in his petition with respect to that year.

E. Regenburg & Sons was organized in 1903 to manufacture and deal in tobacco products. It took over the business of a family partnership which had already prospered in that field; its business career has been remarkably successful. The corporation had a capital stock of 1,000 shares of par value of $100 each. This capitalization has remained unchanged, and the shares have never been held outside the Regensburg family. The holdings of the brothers who are petitioners here are shown in the following tabulation:

	1903	1931	1939	1940
Mortimer	230	264	281½	281½
Isaac	230	264	264	268⅜
Jerome	140	174	174	178⅜
Melville	50	114	114	118⅜

Ever since the business was incorporated the brothers have maintained individual open accounts in which withdrawals were debited and salaries, dividends, interest and other items were credited. Withdrawals were made at will, and have not been proportionate to their stockholdings. Smaller shareholders who were not officers or directors made no withdrawals, receiving only such funds as were paid in the form of declared dividends. Between 1903 and 1935 dividends totalling $2,270,000 were authorized. None has been declared during the tax years in suit, and the corporation shows an operating loss for each of said years, although the surplus on January 1, 1936 was some $4,850,000 and remained more than $4,000,000 on December 31, 1940.

During all the tax years in question, with one exception,* the petitioners made withdrawals in excess of the credits to their open accounts and did not report them as income. The commissioner treated such net withdrawals as dividend distributions within the meaning of section 115(a) and (b) of the Revenue Acts of 1936 and 1938, Int.Rev.Code, § 115, 26 U.S.C.A. Int.Rev. Code, § 115. The tax court sustained his ruling. This resulted in the deficiency assessments of which the petitioners complain. The principal question is whether the tax court's finding that the withdrawals were dividend distributions rather than loans is supportable. The facts are not in dispute; only the inferences to be drawn from them.

Except in a few early years and in 1939 as already noted, withdrawals by each taxpayer have exceeded credits to him so that the debit balance of each has mounted steadily. The total of their debits and credits from 1903 to the end of 1940 and their net debit balances on the latter date were as follows:

	Cash withdrawn or paid on his behalf by corporation 1903–1940	Salary	Credits Dividends	Miscellaneous	Total net debit balance Dec. 31, 1940
Mortimer	$2,560,845	$1,140,900	$555,000	$115,556	$ 749,388
Isaac	3,511,566	1,140,900	555,000	137,994	1,677,671
Jerome	1,535,028	861,595	394,800	73,578	250,053
Melville	1,401,400	752,645	211,650	38,185	398,919

No interest was accrued or paid and no note or other evidence of indebtedness was ever given for the debit balances. They were carried on the corporation's books as "accounts receivable", however, and were reflected in its statements of surplus, constituting a substantial part thereof. The taxpayers owned practically no property except their stock in the corporation, and no other income producing property. In 1912 Isaac was credited with a cash repayment of $10,000 and in 1924 with a cash repayment of $15,000 neither of which sufficed, however, to give him a net credit balance for those years.

Melville protested to his brothers from time to time as to the withdrawals and promises were given to discontinue or reduce them. In 1934 all the shareholders of the corporation entered into a written agreement that if any of them should sell any of his shares while indebted to the corporation the purchase price should first be applied to discharge such indebtedness without interest; or, if the corporation were the purchaser, the amount of the indebtedness should be deducted from the purchase price.

* In 1939 the account of each of the brothers was credited with $14,912.66, his distributive share of their mother's credit balance on the corporation's books at the time of her death. This item plus other usual credits produced credit balances in the accounts of Mortimer, Jerome and Melville.

In either event the shareholder was to remain liable for any unpaid balance of his debt to the corporation. As collateral security the corporation was given a lien on the shares, and a reference to the agreement was endorsed on the stock certificates. The certificates so endorsed were delivered to the corporation and are still held by it. None of the taxpayers ever sold any shares. The stock they bought in 1939 and 1940 was similarly deposited by them under the 1934 agreement. Minutes of a meeting of the board of directors held in May 1938 show that Mortimer stated that heavy losses in recent years and the large loans made to its officers had placed the corporation in an unsatisfactory condition and that such loans must cease. All salaries were then reduced 25% and a resolution was adopted "that effective at once no withdrawals of cash for the purpose of loans to officers be permitted." Nevertheless withdrawals continued to be made.

In 1942 the corporation filed a claim against the estate of Jerome, who died in 1941, for $251,277, representing "loans and advances" secured by collateral lien on his shares in the corporation. No objection was made to the claim by his executrix and it has been recognized as a duly proven and binding claim.

During the years 1936 to 1940, inclusive, the net withdrawals of the taxpayers totaled $171,157.50 for Mortimer, $270,475.65 for Isaac, $92,499.52 for Jerome and $80,252.85 for Melville. The tax court found that each of the amounts making up these totals was a distribution of earnings after February 28, 1913.

Subdivision (a) of section 115 of the applicable Revenue Acts defines "dividends" as "any distribution made by a corporation to its shareholders . . . (1) out of its earnings or profits accumulated after February 8, 1913, or (2) out of the earnings or profits of the taxable year . . . "; and subdivision (b) provides that every distribution is to be deemed made out of earnings to the extent thereof. The petitioners urge that the evidentiary facts established by the record bound the tax court to infer that their withdrawals were received as loans rather than distributions of corporate earnings. They make a very plausible case. All the documentary evidence, including the corporation's books, is consistent with the theory of loans. Had the tax judge drawn the desired inference we could not say it was unsupported by substantial evidence. But he inferred the opposite and, if it was a permissible inference, we must accept it. It is not an appellate court's function "to weigh the evidence, to draw inferences from the facts, and to choose between conflicting inferences." *Wilmington Trust Co. v. Helvering,* 316 U.S. 164, 168. For reasons about to be stated we think the inference was a permissible one.

That the withdrawals were recorded on the corporate books as debits against the taxpayers; that they were not proportionate to holdings of stock nor participated in by all the shareholders;

and that the formalities of a dividend declaration were lacking is not conclusive against a finding that the withdrawals were dividends. *Chattanooga Sav. Bank v. Brewer,* 6 Cir., 17 F.2d 79, certiorari denied 274 U.S. 751; *Hadley v. Commissioner,* 59 App.D.C. 139, 36 F.2d 543; *Christopher v. Burnet,* 60 App.D.C. 365, 55 F.2d 527; *Anketell Lumber & Coal Co. v. United States,* 1 F.Supp. 724, 76 Ct.Cl. 210; *cf. Wiese v. Commissioner,* 8 Cir., 93 F.2d 921, certiorari denied 304 U.S. 562. If the sums withdrawn were actually intended to be loans, it seems extraordinary that they should have been allowed to roll up for nearly forty years until they reached the staggering total of more than $3,000,000 owing by persons who had nothing but their shares of stock with which to pay. The book value of the stock computed without including the petitioners' "loans" as assets was about $1300 per share at the end of 1940. Hence the debt of each taxpayer was greater than the value of his shares. In the case of Isaac Regensburg his debit balance of $1,677,671 was greater than the book value of his stock even when computed with the petitioners' debit balances included at full value. If, however, the withdrawals were actually intended as a method of dividing up the profits or the business according to the respective needs of the petitioners, the only extraordinary feature of the practice would be the inequality in amounts severally withdrawn by them. The total of all withdrawals has never absorbed so much of the available surplus as to jeopardize the financial position of the corporation. Some measure of assurance that the amounts might ultimately be evened up was furnished by the 1934 agreement, which provided that if shares were sold the seller's indebtedness to the corporation should be taken out of the purchase price. Thus the other shareholders assured themselves of an even distribution of earnings in so far as the value of the shares could effect it. The petitioners urge that this agreement alone should dispel any doubts that the withdrawals were recognized as debts. But Judge Sternhagen held that its mere existence did not conclusively characterize the withdrawals as debts, and we agree. Nor do we disagree with his view that the filing of a claim against Jerome's estate and its allowance without objection is not conclusive, considering the date of the occurrence (after dispute had arisen as to the petitioners' taxes) and the intimate family relationship involved. Judge Sternhagen concluded "from all the evidence that a consistent practice in a family corporation of withdrawing the corporation's earnings on an open account, with only negligible repayments in almost the entire forty years of the corporation's existence, indicates an established method of dividend distribution." We think the evidence to support his finding that the withdrawals were not loans is such that we cannot upset it. . . .

Orders affirmed.

Note

See Werner, "Stockholder Withdrawals—Loans or Dividends?" 10 Tax L.Rev. 569 (1955).

Suppose a credit is made to a stockholder's account, thus reducing his indebtedness to the corporation, but without any actual payment. This has been held to be a dividend. See *Waggaman v. Helvering,* 78 F.2d 721 (C.A.D.C., 1934); *Hash v. Commissioner,* 273 F.2d 248 (C.A.4th, 1959).

UNITED STATES v. E. REGENSBURG & SONS

United States Court of Appeals, Second Circuit, 1955. 221 F.2d 336.

GALSTON, DISTRICT JUDGE. The primary question presented on these appeals is whether payments made to the stockholders of this family corporation were dividends, as the Government contends, or loans, as the appellants contend. In essence the same or similar question was presented to this court in *Regensburg v. Commissioner,* 144 F.2d 41, cert. den'd, 323 U.S. 783, and nothing that appears in the record herein warrants a different conclusion as to the nature of those payments.

The corporate defendant was engaged in the manufacture of cigars. It was a typical family business in that all of its capital stock, consisting of 1000 shares, was issued to Edward Regensburg, the founder, and his five sons. He and the sons were the sole officers and directors of the corporation.

The tax liabilities against Isaac Regensburg and Bellette Regensburg or their estates, as a result of the decision of the Commissioner of Internal Revenue in 1942, are the same tax liabilities which the plaintiff is seeking to collect in these suits. Notices of liens for such taxes were filed by the Government on January 17, 1945. At the time of Isaac's death, on December 1, 1943, the accumulated amount of his withdrawals from the company in excess of the amounts accrued to his account was $1,700,610.87. At the end of 1943 the amount of withdrawals by Bellette amounted to $317,719.45. He died on February 17, 1944. It was only after the deaths of Isaac and Bellette that the corporation made demand for the repayment of the foregoing sums on the theory that they constituted loans. In 1947 and 1948 the corporation foreclosed its alleged liens on the shares of stock held by their respective estates, and the corporation bid in the stock of Isaac for the sum of $275,000 and that of Bellette for $110,000, and applied the purchase price in partial discharge of the alleged indebtedness of those two estates.

Section 3670 of the Internal Revenue Code provides that upon failure to pay taxes after demand a lien shall arise in favor of

the United States, "upon all property and rights to property, whether real or personal, belonging to the delinquent taxpayer."

The question to determine is: What rights to the stock acquired by the corporation, formerly in the name of Isaac and Bellette Regensburg or their estates, did the corporation have on the date that the Government filed its tax liens?

As was said by Judge Swan in *Regensburg v. Commissioner*, supra, at least for the tax years 1936 to 1940 inclusive:

> "That withdrawals were recorded on the corporate books as debits against the taxpayers; that they were not proportionate to holdings of stock nor participated in by all the shareholders; and that the formalities of a dividend declaration were lacking is not conclusive against a finding that withdrawals were dividends," citing *Chattanooga Savings Bank v. Brewer*, 17 F.2d 79, cert. den'd 274 U.S. 751, etc.

In respect to the contention made in the earlier case, and repeated here, that the payments were loans and should not be classified as dividends, it is significant that no note was ever executed to evidence any indebtedness on the part of the shareholders, and no interest was ever paid or accrued on the balances shown in their accounts.

If the sums that had been withdrawn from this family corporation by the stockholders were dividends and not loans, then the corporation could not acquire the shares of stock of Isaac and Bellette, because they were not indebted to the corporation. Nor are the defendants aided by New York State law. Such cases as *People ex rel. Fox Film Corp. v. Loughman*, 259 N.Y. 30; *Matter of Calder v. Graves*, 261 App.Div. 90, aff'd 286 N.Y. 643; and *Groh's Sons v. Groh*, 80 App.Div. 86, all sustain the principle of law that if the sums in question were withdrawn with the acquiescence of all the stockholders and without any insistence that they be repaid, they must be regarded, in New York law, as dividends, and not as loans. Nor is the appellant helped by *Ellner Co. v. Isaacson*, 165 N.Y.Supp. 942, or *Famous Realty, Inc. v. Frindel*, 135 N.Y.Supp.2d 261.

The Government's liens, under Section 3672 of the Internal Revenue Code, accordingly must prevail over the underlying pledge agreement of 1934, because that agreement was not supported by a valid loan.

The evidence supports the district court's conclusion, which is on all fours with the holding in *Regensburg v. Commissioner*, supra, that the withdrawals were in fact of earnings. Even the payment by the estate of one brother, Jerome, of the alleged overdraft due from him goes only to the weight of the evidence. This occurred after the institution of the Government's actions, and little if any weight should be attached to that circumstance.

The judgments are affirmed.

Notes and Problems

(A) See, generally, Seidman, "The Unexpected, Untimely and Uninvited Dividend," 36 Taxes 166 (1958); Brafford, "The Constructive Receipt of Dividends by Stockholders of a Closely Held Corporation," 46 Kentucky L.Rev. 515 (1958). See also Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 131–166.

(B) A corporation had two shareholders, A and B. A dispute arose between them, and B offered either to sell his shares for $37,500, or to buy A's shares for the same amount. A accepted B's offer to sell his shares. Pursuant to the agreement, B delivered his shares to a bank; and A delivered to the bank the corporation's check for $37,500. The bank then delivered B's shares to A, and shortly thereafter, A turned them into the corporation, and they were cancelled. It was held that this was a dividend of $37,500 to A. *Frank P. Holloway,* Memo. T. C., December 12, 1951, aff'd (mem.) 203 F.2d 566 (C.A.6th, 1953). See also *Earle F. Tucker,* 23 T.C. 115 (1954).

Could the transaction have been differently planned so as to avoid a dividend? After the transaction as it was carried out, what is A's basis for his stock?

(C) Corporation X, having earnings and profits, distributes to its shareholders stock which it owns in corporation Y. This is a dividend to the shareholders at the fair market value of the Y stock. *Peabody v. Eisner,* 247 U.S. 347 (1918).

As this case shows, a dividend may be in property as well as cash. See also secs. 301(b) and 317(a) of the 1954 Code. A distribution of stock in another company than the one making the distribution is not a "stock dividend." That term is reserved for distributions made by a corporation in its own stock.

(D) The X corporation offered to its shareholders the right to buy stock in the Y company, which it held, at $25 a share. Warrants evidencing this right reached the stockholders a few days after the declaration. The Board found that $25 was the fair market value of the Y shares on the date of declaration, but the market value was greater when the rights were actually received and when they were exercised. Did either the receipt or the exercise of the rights result in income to the X shareholders? *Palmer v. Commissioner,* 302 U.S. 63 (1937), discussed in "Taxability of Stock Purchase Warrants Issued to Shareholders," 51 Harv.L.Rev. 515 (1938). See also 47 Yale L.J. 139 (1937).

DUCROS v. COMMISSIONER

United States Court of Appeals, Sixth Circuit, 1959. 272 F.2d 49.

WEICK, CIRCUIT JUDGE. This is an appeal from a decision of the Tax Court sustaining a deficiency in income tax and an addition thereto for the year 1951.

The sole issue is whether the proceeds of a life insurance policy paid to Mrs. Phyllis A. Ducros, upon the death of Carlton L. Small, are taxable to her as income. Section 22(b)(1)(A) of

the Internal Revenue Code of 1939 exempts from taxation amounts received under a life insurance contract, paid by reason of the death of the insured.

Carlton L. Small was the President of Smead & Small, Inc., at the time of his death on or about July 31, 1951. At that date Francis H. W. Ducros was the Treasurer of the corporation, and his wife Phyllis owned ten shares of its stock.

On or about May 17, 1938, insurance was taken out on the life of Carlton L. Small with the New England Mutual Life Insurance Company in the amount of $15,000. It is stated in the opinion of the Tax Court that "the policy was taken out by the corporation on the life of its president, Carlton Small." This conclusion was apparently founded on Stipulation of Fact No. 3 which recites, "on or about May 17, 1938, Smead & Small, Inc. * * * insured the life of Carlton L. Small * * *"

Irrespective of the conclusion, it is clear, from the documentary evidence submitted with the Stipulation of Facts, that the written application for the policy of insurance was signed on May 17, 1938, by the insured, Carlton L. Small alone. He named Smead & Small, Inc., as beneficiary and reserved to it the right to change the beneficiary. One month later the corporation became vested with all the incidents of ownership of said policy, by virtue of an endorsement thereon and changed the beneficiaries to Marie O. Smead, Constance S. Small and Francis H. W. Ducros. Several changes in beneficiaries were made thereafter. As of February 1950, and continuing until the death of Carlton L. Small, the beneficiaries were Phyllis A. Ducros as to 40% and Constance S. Small as to 60% of the proceeds. It was admitted that the insurance was procured, and all premium payments made by the corporation, pursuant to a predetermined plan. Only the proceeds payable to Phyllis A. Ducros are in issue here. . . . [1]

The Government contends that the judgment below was correct and should be affirmed, although on a different ground than that relied upon by the Tax Court. . . . It renews its contention, made in the Tax Court though not adopted there, that the proceeds of insurance constituted a taxable dividend to appellants. The Government points out that the corporation carried the policy on its books as an asset, paid the premiums, had full rights of ownership and could have changed beneficiaries under it at any time. All of these factors relate to the policy itself, and do not touch on the matter of the proceeds of the insurance.

Section 115(a) of the Internal Revenue Code of 1939, defines a dividend as:

> "any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its

[1] A portion of the opinion, holding that the insurance contract was valid, and not "a wagering contract," is omitted.

earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * *."

By the terms of the statute the proceeds of the policy in question do not qualify as a dividend. The distribution was not made by the corporation. The proceeds of insurance were never an asset of Smead & Small, Inc. At no time did the corporation have either legal or equitable title thereto, or possession or control thereof. Upon the death of the insured, the interest of the beneficiaries in the insurance, which theretofore had been contingent or inchoate, became vested and the proceeds thereof were paid by the insurance company direct to the beneficiaries as required by the provisions of the insurance contract. Hence, in no sense were they a dividend. Cf. *Stern v. Commissioner*, 6 Cir., 1957, 242 F.2d 322, affirmed 357 U.S. 39; *Katz v. Ohio National Bank*, 1934, 127 Ohio St. 531, 191 N.E. 782; *Oetting v. Sparks*, 1923, 109 Ohio St. 94, 143 N.E. 184.

In both *Cummings v. Commissioner*, 1 Cir., 1934, 73 F.2d 477, and *May v. Commissioner*, 20 B.T.A. 282, the proceeds of a life insurance policy were paid to the corporation and thereafter distributed by the corporation to its shareholders. Those distributions were properly considered dividends under the statute. *Golden v. Commissioner*, 2 Cir., 1940, 113 F.2d 590, concerned a plan of distribution whereby the proceeds of life insurance policies procured by a corporation were paid into a trust fund and the fund distributed by a trustee to the shareholders. In that event, the stockholders were deriving their income from the trust created for their benefit by the corporation, i. e., as a distribution made by the corporation through the instrumentality of a trust agreement. Therefore, it may be questioned whether, in such a case, the shareholders were receiving "amounts under a life insurance contract by reason of the death of the insured", even though the trust corpus was composed entirely of the insurance proceeds.

But the Government urges that "The transactions here must be considered as if the corporation had received the proceeds (which had been purchased by premiums paid out of corporate funds) and then had distributed them to its shareholders. The short-cut method used by which the corporation designated beneficiaries who were to receive directly the proceeds from a policy which it alone owned is of no consequence in determining the taxability of the proceeds."

Since the corporation was not entitled to receive the proceeds of the insurance under the provisions of the insurance contract and did not in fact receive them, we are unable to consider the case as if it had. We cannot ignore the plain language of the

insurance contract and the payment actually made by the insurance company to the beneficiary thereunder.

We have not considered the right of the Government to tax the premiums paid as a dividend to the beneficiaries or to follow the cash surrender value of the insurance into the hands of the beneficiaries as these questions were not presented either to the Tax Court or here.

Since under Ohio law the contract of life insurance was a valid one at its inception, and the proceeds thereof were received by appellants "under a life insurance contract by reason of the death of the insured" rather than as a "distribution made by the corporation to its shareholders", it follows that the judgment of the Tax Court should be reversed and the cause remanded to that Court for further proceedings consistent with the views herein expressed.

Notes

(A) Did the court overlook the possibility that a dividend might be paid by merely setting the stage, so that there is a "transfer" at some subsequent time, even though there is no "declaration" of a dividend, and no further action by the corporation? Compare the cases under the Gift Tax, where a gift may be made merely as a result of the lapse of time, if a "transfer" occurs. See page 978 (G), below. For discussion of the *Ducros* case, see Lawthers, in 12 J. of Taxation 92 (1960).

(B) Were dividends paid in the principal case when the premiums were paid on the policies? Would there have been dividends on the payment of the premiums, if the policies had then been irrevocably owned by the shareholders? See *Lewis v. O'Malley,* 140 F.2d 735 (C.C.A.8th, 1944).

(C) Suppose a corporation sells property to a shareholder at less than its fair market value. Is this a dividend? See page 533 (B), above.

B. "EARNINGS AND PROFITS"

By the terms of sec. 316 of the 1954 Code, a distribution by a corporation to its shareholders is a dividend only if it is paid out of "earnings and profits," but it may be paid out of either (a) accumulated earnings and profits, or (b) earnings and profits of the taxable year in which the distribution is made. Thus there may be a dividend even though the corporation has an over-all deficit in earnings and profits, if there are earnings and profits of the current year. *William G. Maguire,* 21 T.C. 853 (1954). Each distribution is regarded as made out of earnings and profits "to the extent thereof, and from the most recently accumulated earnings and profits." Sec. 316 of the 1954 Code. This rule is, however, subject to exceptions, as in the case of distributions in liquidation.

Although sec. 312 contains some elaborate and complicated provisions on the effect of certain distributions on earnings and profits, the concept of "earnings and profits" is not generally defined in the statute. See Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 141–149.[1] It is not the same as the "surplus" of the corporation, and may be very different than the "surplus" appearing on the corporation's books. Similarly, it is not the same as the corporation's "accumulated taxable income." These facts may be seen by the following examples:

(1) Interest on state or municipal bonds does not go into taxable income, but it does increase earnings and profits.

(2) The distribution of a non-taxable stock dividend reduces surplus (the effect of a stock dividend is to capitalize surplus), but it does not reduce earnings and profits.

Consider the effect of the following items on "earnings and profits":

Property received by gift.

Proceeds of life insurance on the life of a corporate officer paid by reason of the death of the officer.

Capital losses—which may be non-deductible.

Appreciation in value of property without a sale.

Gain which was not recognized for tax purposes because it was derived in a reorganization.

COMMISSIONER v. GOLDWYN

United States Court of Appeals, Ninth Circuit, 1949. 175 F.2d 641.

ORR, CIRCUIT JUDGE. In 1942 respondent received a distribution in the amount of $800,000 from Samuel Goldwyn Studios, Inc., a corporation in which respondent owned all the outstanding shares. The principal source of the distribution was a reduction surplus created by corporate resolution reducing the par value of the capital stock and the stated capital of the corporation. The Commissioner determined that the sum of $239,059.58 of

[1] For general discussions of the problem, see Andrews, "'Out of Its Earnings and Profits': Some Reflections on the Taxations of Dividends," 69 Harv.L.Rev. 1403 (1956); Albrecht, "'Dividends' and 'Earnings or Profits,'" 7 Tax L.Rev. 157 (1952); Emmanuel, "Earnings and Profits—An Accounting Concept?" 4 Tax L.Rev. 494 (1949); Drye, "Earned Surplus and Its Problems for the Stockholder," 4 Tax L.Rev. 421 (1949); Reno, "Earnings and Profits," 80 J. of Accountancy 207 (1945); Kehl, Corporate Dividends (1941); Rudick, "'Dividends' and 'Earnings or Profits' Under the Income Tax Law: Corporate Nonliquidating Distributions," 89 U. of Pa.L.Rev. 865 (1941); Paul, "Ascertainment of 'Earnings or Profits' for the Purpose of Determining the Taxability of Corporate Distributions," 51 Harv.L.Rev. 40 (1937), also in Paul, Selected Studies in Federal Taxation 149 (1938).

the distribution was from accumulated and current earnings and therefore constituted a taxable dividend. See § 115(a) and (b) and § 22(a) of the Internal Revenue Code. We are asked to review a decision of the Tax Court sustaining respondent's contention that the sum of $104,610.56 only constituted a distribution from accumulated and current earnings.

The amount of corporate accumulated and current earnings available for distribution in 1942 is dependent upon the character of transactions that occurred many years prior thereto. Samuel Goldwyn Studios, originally organized as United Artists Studio Corporation, was organized to acquire and make available to its shareholders, who were producers of motion pictures, studio facilities to meet the needs of their operations. In 1930 there were five shareholders, exclusive of the holders of qualifying shares. It was the practice of these shareholders to lease from the Samuel Goldwyn Studios corporation office space, stage space, equipment, services and other facilities while working on their productions. Running accounts were maintained with the corporation, and each shareholder was regularly billed for charges he incurred.

At the end of its fiscal year ended June 30, 1930 the corporation had accumulated and current earnings totaling $286,399.42. By resolution of its board of directors made and entered on September 11, 1930, a cash dividend in the amount of $203,091 was declared payable December 15, 1930. Pursuant to the resolution an entry was made in the corporate books debiting surplus with the amount of the dividend and crediting each of the stockholders with his proportionate share thereof, under the title "Dividends Payable". During the fiscal years ended June 30, 1931, 1932, and 1933, the corporation sustained statutory net losses of $97,650.97, $28,475.54, and $101,349.36, respectively. The declared dividend of 1930 was not paid, nor did the shareholders request payment until June 27, 1933, at which time they instructed the corporation by letter, to credit the amounts due them to their running accounts with the corporation. Appropriate entries were made dated May 27, 1933.

The relevancy of the above transactions to the question of respondent's income tax in 1942 is this: If corporate accumulated and current earnings were reduced by the declaration of the dividend in 1930, the 1942 distribution was made out of accumulated and current earnings in the year 1942 to the extent of $104,610.56. If, on the other hand, the application of the dividends to the shareholders' accounts in 1933 reduced corporate earnings and profits and paid in capital in the year 1933, by which time considerable losses had been suffered, subsequent corporate income raised the amount of earnings and profits above the capital level to the extent of $239,059.58 in 1942, as determined by the Commissioner.

The Commissioner's argument is based on § 115(a) of the Internal Revenue Code,[1] defining dividends. He contends that under § 115(a) the dividend was not paid until 1933 and therefore, corporate earnings and profits were not reduced until that time, and relies on cases announcing the rule that time of payment, rather than time of declaration, governs the date of dividend. The purpose of the definition of dividends contained in § 115(a) is to provide an accurate method for their inclusion in gross income under § 22(a). Section 115(a) is primarily concerned with shareholder-taxpayers, the extent of whose liability may depend on whether the dividend is income on the date of declaration or the date of payment.

The cases cited by the Commissioner, which turn on the construction of § 115(a), involve the question of the income tax liability of recipients of dividends. The question in the instant case is not concerned with tax liability of the shareholders because of the dividend; rather, our problem concerns the amount of corporate surplus after the declaration of the dividend, or, more specifically, whether the corporation had in its surplus after the fiscal year ended June 30, 1931, the amount which it had declared as a dividend on September 11, 1930. Section 115(a) does not purport to afford us a basis for a solution because, as we have stated, we are not determining the tax liability of dividend distributees.

In prior cases the Tax Court has recognized that a dividend may be treated by the corporation to reflect its surplus in a manner independent from its effect on shareholders' income under §§ 115(a) and 22(a) of the code. In *Proctor v. Commissioner,* 11 B.T.A. 235, it was held that insofar as the tax liability of the shareholder is concerned the date of payment of the dividend is decisive, although for the purpose of showing the financial status of the declaring corporation its earnings may be reduced as of the date of declaration.

At the date of payment, 1933, the corporation had suffered large losses which occurred subsequent to June 30, 1930, the year surplus and current earnings were recorded at $286,399.42. In fact, in 1933, the amount to the credit of the surplus account was much too small to absorb the distribution. The Commis-

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[1] Section 115(a) in 1942 read as follows:

"Definition of Dividend.—The term 'dividend' when used in this chapter (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

sioner's argument, if given effect, would lead to the conclusion that the major share of the distribution came from the capital account. He determined that the distribution in 1933 reduced paid in capital by $134,449.02 and reduced available accumulated earnings and profits by $68,641.98. However, it is not suggested that the distribution was not intended to be a bona fide dividend taken solely from the profits of the corporation.

We think the problem presented is primarily one of accounting in the absence of the application of § 115. The question is simply whether it was proper to charge surplus and current earnings with the amount of the dividend in the fiscal year ended June 30, 1931, the year it was declared, in order to accurately reflect the financial status of the corporation. Thus stated it is apparent that what is sought is the financial structure of a corporate organization at a given time, an accurate presentation of which is the very purpose and function of accounting. We find support for this analysis in rulings of the Treasury Department. Regulations 111, § 29.115–3 states: "In determining the amount of earnings or profits . . . due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income." Also see, *I.T. 3758,* C.B. 1945, p. 159. In *Commissioner v. James,* 2 Cir., 49 F.2d 707, 708, it is stated that: "In employing the phrase 'earnings and profits' in section 201,[2] we think Congress intended the use of the term in the ordinary accounting understanding, . . . ".

The Commissioner cites many cases holding that book entries or accounting practices are not controlling in tax matters. We do not question the accuracy of those decisions. They involve issues as to whether certain transactions come within the import of various code sections. Of course, what an accountant or bookkeeper enters in the books in a given case does not govern the applicability of statutory provisions. Such entries, however, may have evidentiary value. To say that book entries control would permit tax statutes to be circumvented by skillful accountants. In the instant case no tax dodging scheme is involved. The substance of a transaction, rather than its book entries, determines its taxability. We are not here concerned with the taxability of the transactions between 1930 and 1933. The tax consequences of the 1930 declaration did not manifest themselves for 12 years, and were wholly unpredictable in 1930. As we have stated, application of § 115(a) is not involved here.[3] The deter-

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2 § 201 of the Revenue Act of 1918 corresponds to § 115 of the present code.

3 But see §§ 115(*l*) and (m), where under situations there described earnings and profits to the extent specified would be determined by applying those sections of the code.

mination of the amount of capital and surplus levels of the corporation in 1930 and 1933 depends solely on an accurate accounting of corporate assets and liabilities at those times.

With the issue thus defined its resolution becomes clear. It is well settled that the declaration of a dividend incurs a debtor-creditor relationship between the corporation and its shareholders. *Commissioner v. Scatena,* 9 Cir., 85 F.2d 729, 731; *United States v. Guinzburg,* 2 Cir., 278 F. 363. See also, *Commissioner v. Miller Mill Co.,* 5 Cir., 102 F.2d 599, a case arising under the Internal Revenue Code. Accountants uniformly follow the logical consequence of the relationship thus created by immediately reducing surplus and current earnings and crediting accounts payable by the proper amount. See, W. A. Paton, Accountants' Handbook, 3rd Ed., pp. 1041, 1042. It would be an inaccurate reflection of the corporation's financial standing to list an amount as surplus which in fact was due and owing under a legally enforceable obligation. The Securities Exchange Commission follows the same rule in its uniform system of accounts. Regulation S-X of S.E.C., Art. 5, Rule 5.02, Sub. 25, 3 CCH Fed.Sec.Law Service, paragraphs 69242 and 70311. To similar effect see *Gregg Co.,* 25 B.T.A. 81; *Belmont Iron Works,* 9 B.T.A. 216; *W. E. Caldwell Co.,* 6 B.T.A. 47; *Bulger Black Coal Co v. United States,* 48 F.2d 675, 71 Ct.Cl. 636. The corporation correctly reflected its accumulated and current earnings as reduced by the amount of the dividend in 1930.

An alternative contention, urged by respondent and sustained by the Tax Court, is to the effect that shareholders constructively received the dividend in 1930 and that corporate surplus and earnings were thereby reduced in that year. Because of the conclusion we have reached as to the effect of the declaration of the dividends in 1930 we think it unnecessary to discuss this alternative contention.

Affirmed.

Note

Pre–1913 Earnings

In *Lynch v. Hornby,* 247 U.S. 339 (1918), a dividend was paid in 1914 out of surplus which had been earned before March 1, 1913. The Court held that this distribution was taxable as income. Compare this result with *Lynch v. Turrish,* 247 U.S. 221 (1918), *supra,* p. 618, which was decided on the same day. Since the Revenue Act of 1916, Congress has refrained from taxing distributions paid out of earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913. See secs. 316(a)(1) and 301(c)(3)(B) of the 1954 Code. But such profits cannot be distributed as long as there are subsequent profits available. The presumption of the statute in this respect is not rebuttable. See *Faris v. Helvering,* 71 F.2d 610 (C.C.A.9th,

1934), cert. den. 293 U.S. 584 (1934). For the effect of intervening losses on the question of the source of the distribution see *Helvering v. Canfield,* 291 U.S. 163 (1934).

COMMISSIONER v. TIMKEN

United States Circuit Court of Appeals, Sixth Circuit, 1944. 141 F.2d 625.

HICKS, CIRCUIT JUDGE.[1] . . . In accordance with the stipulation of facts, the Board found that the Imperial Investment Company, a corporation, was organized in 1930. So far as is material here, it had a capital of 800 shares having a par value of $100 per share. The decedent owned 300 shares of this stock. The Investment Company kept its books on a cash basis and made its income tax returns accordingly. On January 1, 1936, it had no accumulated earnings or profits. Its earnings and profits for 1936 amounted to $247,011.94. In that year it made cash distributions to its stockholders in the sum of $248,000. It owned 12,000 shares of the stock of Twin Coach Company, which it acquired immediately after its incorporation. This Coach Company stock and certain other securities represented the capital of the Investment Company. Its cost to the Investment Company as entered on its books was $30,857.14 and on July 6, 1936, it had a fair market value of $154,500. On July 6, 1936, the Board of Directors of the Investment Company authorized a distribution of these 12,000 shares and on that date the fair market value of the stock distributed to the decedent was $57,937.50. On that date the cash distribution above referred to exceeded the accumulated earnings and profits and the Company then, of course, had no undistributed earnings or profits. Upon its incorporation the Investment Company received property, as capital, worth substantially more than the par value of its stock, and such excess was credited to paid-in surplus. The Investment Company was not in process of liquidation in 1936 and no change was made in its capital during that year. Its stock was not impaired in that year since its surplus was in excess of the par value thereof. The distribution to decedent of the Coach Company shares was taken at their then fair market value and applied by him to reduce his investment in the stock of the Investment Company. The Commissioner contends that the amount of $46,366.07, the difference between the value of the stock when the Investment Company acquired it and when it was distributed to decedent, was taxable. The respondent contends that it was not taxable because it represented a return to the decedent of his capital investment in the shares of the Investment Company. It was clearly not the intention of the Investment Company to distribute the 12,000 shares of the stock of the Coach Company as income or dividends

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[1] A portion of the opinion, dealing with other points, is omitted.

to its stockholders in the sense defined by Sec. 115(a) of the Act of 1936, because it had already, on the day before, distributed to its stockholders $200,000 which represented dividends or income in excess of its earnings for that year. This distribution of its shares was a distribution of its capital because it at that time had nothing else out of which it could make distribution and we think the case must be ruled by Sec. 115(d) headed "Other distributions from capital" which provides that "the amount of such distribution should be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property." The decedent did, upon the receipt of the shares distributed to him, apply them at their market value to reduce his stock investment in the Investment Company.

The Commissioner contends, that regardless of what the Investment Company intended to do, the fact is, that in making its distribution of the Coach Company stock, it distributed to decedent stock worth $57,937.50, which had cost it only $11,571.43, and that the difference was income taxable to decedent; but the difficulty with the proposition is, that a mere advance in the value of the property is not income. It is nothing more than an unrealized increase in value. See Mertens Law of Federal Income Taxation, Vol. 1, p. 169, § 5.05 and cases cited. The transaction represented no gain to the decedent, because, in accordance with a resolution of the board of the Investment Company, as well as the provision of Sec. 115(d), the taxpayer applied the stock distributed to him to the reduction of his investment account in the Investment Company. Upon this issue the decision of the Board is likewise affirmed.

Notes

(A) To the same effect is *Michael P. Erburu,* 23 T.C. 820 (1955).

(B) In *Commissioner v. Hirshon Trust,* 213 F.2d 523 (C.A.2d, 1954), the court reached an essentially contrary result, although it attempted to distinguish the *Timken* case. It held that a distribution of appreciated property was a dividend, even though the corporation did not have earnings and profits in the amount of the fair market value of the stock distributed, if the effect of the distribution was to leave the corporation's capital intact. The same result was reached, with respect to the same distribution, in *Commissioner v. Estate of Godley,* 213 F.2d 529 (C.A.3d, 1954). There are comments on the cases in 54 Col.L.Rev. 1156 (1954); and 68 Harv.L.Rev. 369 (1954).[1] The Supreme Court denied certiorari in both cases. 348 U.S. 861, 862 (1954).

[1] For discussions of the problems, see Scott, "Taxation of Corporate Distributions in Kind," 12 Stanford L.Rev. 529 (1960); Mintz and Plumb, "Dividends in Kind—The Thunderbolts and the New Look," 10 Tax L.Rev. 41, 405

The 1954 Code

(C) Sec. 312 of the 1954 Code provides that when a dividend is paid in appreciated property the earnings and profits of the distributing company shall be reduced by the "adjusted basis" of the property distributed. However, this does not specify the amount that shall be regarded as a dividend. See also secs. 316 and 301(b)(1)(A). But the rule that appreciation does not constitute earnings and profits is clearly stated in sec. 1.316–1(a)(2) of the Income Tax Regulations, and the question seems now to be foreclosed. Indeed, the same result has been extended retroactively to the 1939 Code by sec. 115(n) of that Code, which was enacted by the Act of June 29, 1956.[1]

Although this is the general rule, note the exception in sec. 312(b) with respect to the distribution of certain inventory assets.

Income to the distributing corporation

(D) In *General Utilities and Operating Co. v. Helvering,* 296 U.S. 200 (1935), a corporation made a distribution of appreciated property. It was held that it did not have income from the distribution. This result is now generally prescribed by sec. 311(a) of the 1954 Code.

Under the 1954 Code, there are now certain situations where a corporation may have income from a distribution of appreciated property. See sec. 311(b), relating to distributions of LIFO inventories with appreciated values, and sec. 311(c), relating to distributions of property subject to a liability greater than the basis of the property in the hands of the corporation.

(E) Suppose a corporation declares a dividend of $150,000, and then pays it in appreciated property. Would it derive any income in such a case? Suppose it declares a dividend of "$150,000, payable in X stock at its present value," and X stock is worth more than its basis to the corporation. Would that be different from the previous question? What steps should be taken in drawing dividend resolutions in such cases?

Distribution to a corporation

(F) Note that when the distribution is to a corporation the amount of a dividend received in property is limited by the basis of the property in the hands of the distributing corporation, if

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(1954); Hubbard, "Recent Developments in Dividends in Kind of Appreciated and Depreciated Property," Proc.N.Y.U. 12th Annual Inst. on Federal Taxation 311 (1953); Nelson, "The Dilemma of the Corporation in Tax Accounting for Dividends in Kind," 91 J. of Accountancy 96 (1951); Molloy, "Some Tax Aspects of Corporate Distributions in Kind," 6 Tax L.Rev. 57 (1950); Raum, "Dividends in Kind: Their Tax Aspects," 63 Harv.L.Rev. 593 (1950).

1 For discussion of this and related problems, see Alexander, "Some Earnings and Profits Aspects of the Internal Revenue Code of 1954," 7 Hastings L.J. 285 (1956); Kumler, "Contributions and Distributions of Property in Kind to and by Corporations," 33 Taxes 938 (1955); "Distribution in Kind: Problems Facing a Tax Planner," 30 So.Calif.L.Rev. 520 (1957); North, "Corporate Distribution of Appreciated Property—A Comment on Policy," 36 Nebraska L.Rev. 528 (1957).

that is less than the fair market value. Sec. 301(b) (1) (B). This is a new provision in the 1954 Code. Similarly, the receiving corporation takes the property at the same basis. Sec. 301 (d) (2). This is designed to prevent a corporation from taking in property as a dividend at its full fair market value, then taking the benefit of the deduction of 85% of dividends received, on the full value (see sec. 243(a)), and having the full value as its basis for subsequent purposes such as depreciation, or gain on sale.

The effect of these provisions appears to be to give a 100% dividends received credit for the appreciated portion of dividends paid in property (if any) with an 85% credit for other dividends. In other words, the intercorporate dividend tax is eliminated as far as unrealized appreciation is concerned—which would appear to be as it should be. See also pp. 794–795, below.

Distribution in depreciated property

(G) Reference is made in the principal case to the question of the effect of the distribution of *depreciated* property. Assuming adequate earnings and profits from other sources, it is clear that this is a dividend (both to corporate and other taxpayers) in the amount of the fair market value. Sec. 301(b) of the 1954 Code. What is its effect on the earnings and profits of the distributing company? See sec. 312(a) (3). For cases under the earlier statute, which was less explicit, see *R. D. Merrill Co.*, 4 T.C. 955 (1945); *Reynolds Spring Co. v. Commissioner,* 181 F.2d 638 (C.A.6th, 1950).

In considering the following case, two points should be noted with respect to the direct applicability of the case under the present law:

1. The question arises only if appreciation in value of property is not "earnings and profits," as held in the *Timken* case. It was so decided, or assumed, by the Tax Court in the *Young* case because that has been the consistent position of the Tax Court. As has been indicated, the Tax Court's view on this question is now established by the 1954 Code, and especially by the Regulations under the 1954 Code.
2. The question involved in the *Young* case would not arise in 1954 and later years because of the provision of sec. 301(b) (1) (B) of the 1954 Code. However, the question decided would still arise under the 1954 Code in the case of a non-corporate distributee. Thus, if the Y Corporation in the *Young* case had been an individual with a fiscal year ending on June 30, 1954, the question would be presented—assuming that the *Hirshon Trust* decision is not followed.

YOUNG v. COMMISSIONER

Tax Court of the United States, 1946. 6 T.C. 357.

[Although this case is entitled in the name of an individual, the proceeding involved three related petitions for review, which were consolidated by the Tax Court. The liability involved in the

following opinion is that of the Young-Wolf Corporation (hereafter called Y), and the Tax Court had jurisdiction of that company's liability only with respect to a deficiency determined for its taxable year 1937, which was a fiscal year ending November 30, 1937.

In *Young v. Commissioner*, 5 T.C. 1251 (1945), it appeared that A and B owned nearly all of the stock of Y, which in turn owned all of the stock of G corporation. G owned 1000 shares of stock of Theatrical Managers, Inc. which had cost it $15,828. On November 9, 1937, G transferred this stock to trusts created by A and B for their children. The trustees of the trusts paid for this stock an aggregate amount of $15,828. The court held that since the stock was worth more than the price paid, this transfer amounted to a dividend paid by G to Y to the extent of the earnings and profits of G, and also to a distribution from Y to A and B. In connection with the computation of the deficiency due from Y, the court entered the following "Supplemental Findings of Fact and Opinion."]

MURDOCK, JUDGE. The parties to these proceedings filed recomputations under Rule 50. They were not in agreement and each was heard in support of his recomputation. The Court made a finding in this case that the value of 1,000 shares of stock of Theatrical Managers, Inc., on November 9, 1937 "was in excess of $100,000." See 5 T.C. 1251. It now appears that a more definite finding of value is necessary in order to make computations required by the statute and the regulations of the Commissioner. The following finding is therefore made: The value of the 1,000 shares of Theatrical Managers, Inc. stock, on November 9, 1937, was $225,000.

This finding will enable the parties to make proper computations under Rule 50 provided they follow the statute and the regulations. Section 115(a) of the Revenue Act of 1936 provides that the term "dividend" "means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made." [1] The words "earnings or profits accumulated after February 28, 1913", as used in the above definition, are contrasted with and are not intended to in-

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[1] These other provisions of section 115 were not called to the attention of the Court and were not considered by the Court in writing its original opinion. Thus, two remarks of the Court in regard to earnings available at the time of the distribution were inappropriate and must be disregarded.

clude any of the earnings of the taxable year. Section 115(b) provides that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. It becomes necessary in this case to determine what earnings or profits Gary Theatre Company had for the calendar year 1937 and what earnings it had on December 31, 1936 which had been accumulated since February 28, 1913.

The parties have stipulated facts from which it would appear that the earnings and profits of Gary Theatre Company for the calendar year 1937, computed as of the close of the year without diminution for any distributions, but after adjustment for taxes, amounted to $31,911.25. They have also stipulated that a dividend of $24,000 was paid by the corporation to shareholders on December 28, 1937.

The parties have also stipulated what its book surplus was on December 31, 1936, and they have stipulated certain adjustments which should be made to that surplus. The surplus, after making the stipulated adjustments, amounted to $45,233.73 and we will assume that all of that amount was earnings or profits accumulated since February 28, 1913 although this corporation was incorporated in 1911. The record does not show what part, if any, of its surplus was accumulated prior to March 1, 1913.

It now appears that the corporation made a distribution of $209,172 on November 9, 1937 ($225,000, the value of the Theatrical Managers stock on that date, minus $15,828, the cost of that stock to the distributor) and a distribution of $24,000 on December 28th, or total distributions during the year of $233,172, whereas the entire earnings of the year, computed in accordance with the statute, from which a taxable dividend could be distributed, amounted to only $31,911.25.

It is important to determine what amount of the 1937 earnings was distributed as a part of the November 9, 1937 distribution because that was the only distribution made during the fiscal year of the Young-Wolf Corporation which ended on November 30, 1937. Regulations 94, Article 115–2, expressly covers such a situation. That regulation follows the provisions of the statute. When the words "earnings or profits accumulated since February 28, 1913" are used therein, they have the same meaning as in the statute itself, i. e., they do not include any of the earnings of the taxable year. The Article provides that "If the distributions made during the taxable year exceed the earnings or profits of such year, then that proportion of each distribution which the total earnings or profits of the year bears to the total distributions made during the year, shall be regarded as out of the earnings or profits of that year." The Article further provides that "The portion of each such distribution which is not regarded as

out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution." The portion of the distribution of November 9, 1937, which was made out of earnings or profits of the year 1937 was thus $\frac{\$31,911.25}{\$233,172.00}$ X $209,172,[2] or $28,626.68. The distribution on November 9, 1937, also was a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, on hand at the beginning of the year, or $45,-233.73. Thus, that distribution represented a taxable dividend to the extent of the total of these two amounts, or $73,860.41. No further computations are required or authorized under the statute or under the article of the regulation in a situation like that here present. The problem here, except for the amounts involved, is exactly like the example given in the article at page 261.

The parties are directed to file recomputations in accordance with the findings of fact and opinion as supplemented herein.

Decision will be entered under Rule 50.

Note

The relevant provision of the Regulations is now found in sec. 1.316–2(b) and (c) of the Income Tax Regulations, which should be examined.

C. CANCELLATIONS OR REDEMPTIONS ESSENTIALLY EQUIVALENT TO THE DISTRIBUTION OF A TAXABLE DIVIDEND

Secs. 302–304 of the 1954 Code

COMMISSIONER v. ROBERTS

United States Court of Appeals, Fourth Circuit, 1953. 203 F.2d 304.

DOBIE, CIRCUIT JUDGE. This is a petition by the Commissioner of Internal Revenue to review a decision of the Tax Court of the United States. The Tax Court held that the distribution in connection with the redemption of the stock of the corporation, *under the circumstances of this case,* was not essentially equivalent to, and not taxable as, the distribution of a dividend under section 115(g) of the Internal Revenue Code. We think the decision of the Tax Court was clearly erroneous. It must, therefore, be reversed.

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2 This fraction might be easier to understand if it were stated as $\frac{\$209,172}{\$233,172} \times \$31,911.25$. [Ed].

We quote the applicable provisions of the Internal Revenue Code and Treasury Regulations:

"Internal Revenue Code:

"§ 115. Distributions by corporations

* * * * * * * * *

"(g) *Redemption of stock.* * * * If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

Treasury Regulations 111, promulgated under the Internal Revenue Code:

"§ 29.115–9. *Distribution in Redemption or Cancellation of Stock Taxable as a Dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

"The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will

not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend."

There is little or no dispute about the facts of this case. In March, 1932, John T. Roberts, hereinafter called taxpayer, and his brother transferred to a newly created corporation all of the assets of a wholesale plumbing and heating supply business, theretofore conducted by them in partnership, in exchange for all of the stock of the corporation, consisting of 2,000 shares of common stock, par value $100 each. Fifteen hundred shares were issued to taxpayer, who continued to hold them through the taxable year 1944 here involved. Five hundred shares were issued to taxpayer's brother. Taxpayer's brother died in October, 1943, and by his last will made a specific bequest to taxpayer of any shares of stock of the corporation owned by him at the time of his death. Pursuant to an order of the probate court, the executor of the brother's will transferred to taxpayer stock certificates for the 500 shares of the corporation's stock which the brother had owned. These 500 shares were valued for estate tax purposes at $92,000.

During the war the business of the corporation was adversely affected by Government regulations, and during the period 1941 to 1944 the difficulties of operating increased. Gross sales in 1939 were roughly $771,000; increased to $1,677,000 in 1941; and dropped in succeeding years to a low of $400,000 in 1944. Adjusted net income (that is, prior to taxes) amounted to roughly $28,000 in 1939; $47,000 in 1940; $63,000 in 1941; $106,000 in 1942; $49,000 in 1943, and $13,000 in 1944.

On January 1, 1944, total assets amounted to approximately $414,000 (including cash of $160,000 and United States obligations of $96,000), and the earned surplus amounted to approximately $170,000. As of December 31, 1944 (that is, after the distribution in redemption of stock here involved), the corporation's balance sheets showed assets of $320,000 (including cash of $60,000 and United States obligations of $106,000) and an earned surplus of $135,000.

The corporation paid a dividend of $4 a share in 1934; $16 in 1935; $8 in each year 1936 through 1940; $6 in 1941; and no dividends in 1942 and 1943. In 1944, after the stock redemption hereinafter mentioned, a dividend of $2 was distributed. In 1944 taxpayer also was paid a salary of $27,900 by the corporation as its president.

On December 26, 1944, at a special meeting of the corporation's board of directors, on motion of taxpayer, it was resolved that

the corporation purchase from taxpayer for $92,000 the 500 shares of stock which taxpayer had acquired by bequest from his brother, and that the capital stock of the corporation be reduced to 1,500 shares, par value $100. On the same day, a special meeting of the stockholders (namely, taxpayer, for he then owned all the shares of stock in this corporation,) approved; the transaction was completed; and an amendment to the certificate of incorporation was executed which was later approved by the State Tax Commission. Taxpayer never considered selling his shares to anyone but the corporation because he wanted to keep the stock in the family.

The taxpayer did not report the transaction in controversy on his return, and the Commissioner determined a deficiency on the ground that the amount of $92,000 paid by the corporation was taxable as a dividend.

The Tax Court specifically found that the earnings and profits of the corporation prior to and during 1944 were accumulated for no definite purpose; that the operations of the corporation were not impaired by reason of the transaction in controversy, and that the corporation had never followed a policy of contraction of business; that the corporation's financial position on December 26, 1944, permitted of a dividend of $92,000, and that the corporation continued in the same business in subsequent years.

The Tax Court further found that the payment of the $92,000 to taxpayer by the corporation in the taxable year was a distribution in complete cancellation and redemption of all of that portion of the corporation's stock bequeathed by taxpayer's brother, constituting a partial liquidation, and not the essential equivalent of the distribution of a taxable dividend.

We cannot agree with the holding of the Tax Court that, as of the time of the stock redemption, the stock acquired by taxpayer which was redeemed, must be regarded as the stock of the brother. This runs absolutely counter to reality. This stock had been the brother's; but, months before the redemption, taxpayer's title to this stock had been completely perfected. See, *Matthews v. Turner and Woodyard*, 64 Md. 109, 121, 21 A. 224.

The vital thing here, as we see it, is that, by the redemption of this stock, the *essential relation* of the taxpayer to the corporation was not, in any practical aspect, changed. Before the redemption, he was the sole stockholder in the corporation; after the redemption, he was still the sole stockholder. Of what real consequence was it that before the redemption his sole ownership was divided into 2,000 shares, and after the redemption, this same sole ownership was divided into 1,500 shares: He owned the whole corporation before the redemption; after the redemption, he was still the sole owner.

Here, then, we find a single individual owning all the corporate stock. *Flanagan v. Helvering*, 73 App.D.C. 46, 116 F.2d 937; *Bazley v. Commissioner*, 3 Cir., 155 F.2d 237, 239, affirmed 331 U.S. 737. The corporation had on hand a large and unnecessary accumulation of cash, representing "earnings or profits accumulated after February 28, 1913." *Hirsch v. Commissioner*, 9 Cir., 124 F.2d 24, 29. The corporation did not then intend to liquidate or to contract its business. *Rheinstrom v. Conner*, 6 Cir., 125 F. 2d 790, 793, certiorari denied 317 U.S. 654. The redemption served no business purpose of the corporation; it was motivated entirely by the personal considerations of taxpayer. *Commissioner v. Snite*, 7 Cir., 177 F.2d 819; *Smith v. United States*, 3 Cir., 121 F.2d 692, 695. The net effect of the redemption was clearly to distribute to taxpayer the corporate earnings just as if a cash dividend had been declared. *Kirschenbaum v. Commissioner*, 2 Cir., 155 F.2d 23, certiorari denied 329 U.S. 726; *Hyman v. Helvering*, 63 App.D.C. 221, 71 F.2d 342, certiorari denied 293 U.S. 570. See, also, Nolan, "The Uncertain Tax Treatment of Stock Redemptions: A Legislative Proposal," 65 Harv.L.Rev. 255; Pedrick, "Some Latter Day Developments in the Taxation of Liquidating Distributions," 50 Mich.L.R. 529. Indeed, it is difficult to imagine a more ideal set-up for the application of Section 115(g) than the facts involved in the instant case. . . .

The Regulations, which have been in effect for many years, provide in part that a redemption by a corporation of a portion of its stock *pro rata* among all the shareholders would generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. That provision of the Regulations is fully met in this case, and likewise other factors which have sometimes been held relevant are also present here.

It might be noted that while dividends were paid by the corporation here prior to 1942, no dividends were paid by the corporation in 1942, 1943, or 1944 prior to redemption, though the corporate earnings in all these years were quite substantial.

Any conclusion other than that which we have reached readily shows how easily the tactics of the taxpayer here could be used as a means of tax evasion. A prosperous corporation, for example, with a single stockholder, earns large sums of money, available for, and which should be paid out as, dividends. This sole stockholder siphons off this money (as was done in the instant case) to himself by selling a portion of his stock to the corporation at a price per share which will just cover these earnings. Surely, this is a redemption "essentially equivalent to the distribution of a taxable dividend." Congress must have had just such a situation in mind when it enacted section 115(g).

See cases previously cited and compare, decided by our Court, *Wall v. United States*, 4 Cir., 164 F.2d 462.

The decision of the Tax Court of the United States is reversed and the case is remanded with directions to enter a decision in favor of the Commissioner.

Reversed and remanded with directions.

Notes

(A) The language of sec. 302 (formerly found in sec. 115(g) of the 1939 Code) is rather intricate and difficult. The important words (for present purposes) are found in sec. 302(d) taken together with sec. 302(b)(1). This is a powerful instrument, and must be carefully considered in any situation in which it is contemplated that a corporation may cancel or redeem any part of its stock. It is not limited in its operation to stock which was originally issued as a stock dividend, although that is the situation which first called forth the enactment of the provision.[1]

(B) What becomes of the basis of the stock which is redeemed, if the amount received is held taxable as a dividend under sec. 115(g)? Is it transferred to other stock held (if any), or is it lost—or should it be deductible in some way against the sec. 115(g) tax? See Katcher, "The Case of the Forgotten Basis," 48 Mich.L.Rev. 465 (1950).

Although there is nothing in the 1954 Code on this, the Regulations now state that "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Sec. 1.302–2(c) of the Income Tax Regulations. If all of the stock of one shareholder is redeemed in a transaction that is taxable as a dividend, does this mean that his basis is allocated to the remaining shareholders? See Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 241–242; Brodsky and Pincus, "The Case of the Reappearing Basis," 34 Taxes 675 (1956).

MEYER v. COMMISSIONER

United States Circuit Court of Appeals, Third Circuit, 1946. 154 F.2d 55.

MARIS, CIRCUIT JUDGE. The taxpayer asks this court to review a finding by the Tax Court that the redemption by Bersel Realty Company during the years 1938, 1939, 1940 and 1941 for $125,-

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[1] For consideration of the problems, see Holzman, "The Net Economic Effect Test," 38 Taxes 149 (1960); Bittker, "Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954," 9 Stanford L.Rev. 13 (1956); Windhorst, "Stock Redemptions and Constructive Ownership Problems," 33 Taxes 917 (1955); Leon, "The Role of Constructive Ownership in Determining Whether a Stock Redemption is Taxed As a Dividend or a Capital Gain," 51 Northwestern U.L.Rev. 568 (1956); Rasman, "Stock Redemptions Under sec. 302 of the 1954 Code," 35 Taxes 355 (1957); Bittker, "The Taxation of Stock Redemptions and Partial Liquidations," 44 Cornell L.Q. 299 (1959); Winton, "Stock Redemptions in Closed Corporations," 37 Taxes 397 (1959); Smith, "Recent Developments in the Field of Corporate Business Purchase Agreements," 14 Tax L.Rev. 413 (1959).

000 of 1,250 shares of its 5% noncumulative preferred stock which he owned was accomplished at such times and in such manner as to be essentially equivalent to distributions of taxable dividends to him within the meaning of Section 115(g) of the Revenue Act of 1938 and the Internal Revenue Code. This was a conclusion which ordinarily would not be reviewable here. *Dobson v. Commissioner,* 320 U.S. 489 (1943); *Kelley Co. v. Commissioner,* 521 U.S. 326 (1946).

In the present case, however, this conclusion was based upon a finding that in the years in question the company had undistributed surplus earnings in excess of the amounts distributed in redemption of the stock. That finding in turn depended in part upon a further finding that on December 31, 1937, the earned surplus of the company was $374,433.37. This represented the earned surplus as shown by the company's books of account on that date. The Tax Court also found, however, that in the years 1931, 1934 and 1935 the company had redeemed 5,500 shares of the taxpayer's preferred stock for $550,000.

While the Tax Court found that these redemptions were all charged against the capital account it did not find, and the present record does not disclose any basis for finding, that the redemptions made in 1931, 1934 and 1935 were accomplished at a time and in a manner so different from those made in 1938, 1939, and 1940 and 1941 as not to be also essentially equivalent to distributions of taxable dividends. On the contrary every factor upon which the court relied in concluding that the later redemptions were of this character would seem, so far as appears from the record now before us, equally applicable to the earlier ones.

If, however, the earlier redemptions which totalled $550,000 are also to be treated as essentially equivalent to distributions of taxable dividends it is obvious that, looked at from the tax standpoint, they must have operated to distribute so much of the earned surplus of $374,433.37 shown by the company's books at the end of 1937 as had accumulated up to the time of the last of these earlier redemptions in 1935. In that case only the earnings accumulated since that last redemption would, for tax purposes, have remained available for distribution in 1938 and later years. The Tax Court made no finding as to the amount of the earnings accumulated in 1936 and 1937 and there is no evidence in the record upon which such a finding could be based.

The Tax Court, as we have said, concluded that the entire sum of $125,000 distributed by Bersel Realty Company to the taxpayer in 1938, 1939, 1940 and 1941 in redemption of preferred stock was taxable as dividends. From what has been said it will be seen that this conclusion required for its support a find-

ing either (a) that the redemptions of 1931, 1934 and 1935 were not essentially equivalent to the distribution of taxable dividends and therefore did not for tax purposes operate to distribute the earnings of that period, or (b) that the earnings accumulated after the last of those earlier redemptions together with the earnings of the years 1938, 1939, 1940 and 1941 were at least equal to the amounts distributed in redemption of preferred stock in the latter years. Since the Tax Court made neither finding its decision must be vacated and the case remanded for appropriate findings and decision.

The decision of the Tax Court is vacated and the case is remanded for further proceedings in accord with this opinion.

MEYER v. COMMISSIONER

Tax Court of the United States, 1946. 7 T.C. 1381.

LEMIRE, JUDGE. This proceeding is before us on mandate from the Circuit Court of Appeals for the Third Circuit. In an opinion reported at 5 T.C. 165, we held that certain distributions, in the form of preferred stock redemptions, which the petitioner as sole stockholder received from the Bersel Realty Co. during the years 1938 to 1941, inclusive, were made at such time and in such manner as to be essentially equivalent to distributions of taxable dividends and were out of earnings or profits accumulated after February 28, 1913, within the meaning of section 115(g) of the Internal Revenue Code. On review the Circuit Court remanded the case to us for certain additional findings of fact and decision thereon. The opinion of the Circuit Court reads in part as follows:

"The Tax Court, as we have said, concluded that the entire sum of $125,000 distributed by Bersel Realty Company to the taxpayer in 1938, 1939, 1940 and 1941 in redemption of preferred stock was taxable as dividends. From what has been said it will be seen that this conclusion required for its support a finding either (a) that the redemptions of 1931, 1934 and 1935 [*sic*] [1] were not essentially equivalent to the distribution of taxable dividends and therefore did not for tax purposes operate to distribute the earnings of that period, or (b) that the earnings accumulated after the last of those earlier redemptions together with the earnings of the years 1938, 1939, 1940 and 1941 were at least equal to the amounts distributed in redemption of preferred stock in the latter years. Since the Tax Court made neither finding its decision must be vacated and the case remanded for appropriate findings and decision."

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[1] The parties have stipulated that the reference to the year 1935 is erroneous and that the year 1936 is the correct year. Motion to correct the record accordingly was duly made and granted.

A rehearing was had before this Court on September 24, 1946, at which additional evidence was adduced. The following tabulation prepared from the books of the Bersel Realty Co. shows the accumulated earnings and profits, the current yearly earnings, the stock redemptions in each year, and the accumulated earnings adjusted to reflect the stock redemptions for the years 1931 to 1937, inclusive:

Year	Accumulated earnings and profits as per books	Current earnings for year	Stock redemptions during year	Accumulated earnings and profits adjusted to reflect redemptions (balance)
1-1-31	$175,661.13	....	....	$175,661.13
12-31-31	196,112.13	$20,451.00	$150,000.00	46,112.13
12-31-32	216,278.95	20,166.82	....	66,278.95
12-31-33	225,498.72	9,219.77	....	75,498.72
12-31-34	247,205.88	21,707.16	100,000.00	* (2,794.12)
12-31-35	289,211.00	42,005.12	....	39,211.00
12-31-36	326,316.36	37,105.36	300,000.00	223,683.64)
12-31-37	374,433.37	48,117.01	....	(175,566.63)

There were net earnings of $46,339.20 in 1938, $39,936.34 in 1939, $51,048.55 in 1940 and $60,304.04 in 1941. There were no stock redemptions in 1937. In 1938 there were stock redemptions of $50,000 and further redemptions of $25,000 in each of the years 1939, 1940, and 1941.

The earned surplus of $175,661.13 which the corporation had at the beginning of 1931, plus the earnings for 1931, 1932, 1933, and 1934, was $2,794.12 less than the total of the stock redemptions in 1931 and 1934. The further stock redemption of $300,000 in 1936 exceeded the earnings of 1935 and 1936 by $220,889.52 and resulted in an impairment of capital at January 1, 1937, of $223,683.64. That capital impairment was reduced by 1937 earnings to $175,566.63 at the close of that year and the beginning of the first taxable year 1938.

The stock redemptions of the prior years 1931, 1934, and 1936 constituted taxable dividends only to the extent of the accumulated earned surplus and current earnings available for dividend distributions in those years. To the extent that they exceeded the accumulated earned surplus and current earnings they were distributions of capital.

Thus, as to the first alternative finding suggested by the Circuit Court, we can not find:

. . . (a) that the redemptions of 1931, 1934 and 1936 were not essentially equivalent to the distribution of taxable

* Parentheses denote deficit.

dividends and therefore did not for tax purposes operate to distribute the earnings of that period. . . .

The Circuit Court's second suggested alternative finding is:

. . . (b) that the earnings accumulated after the last of those earlier redemptions together with the earnings of the years 1938, 1939, 1940 and 1941 were at least equal to the amounts distributed in redemption of preferred stock in the latter years. . . .

There were net earnings of $48,117.01 in 1937 and no stock redemptions in that year. In 1938 there were net earnings of $46,339.20 and a stock redemption of $50,000. In 1939, 1940, and 1941 there were net earnings, respectively, of $39,936.34, $51,048.55, and $60,304.04, and $25,000 of stock redemptions in each of such years. It is therefore apparent, and we so find, that the earnings accumulated after the last of the earlier redemptions (which occurred in 1936), together with the earnings for the taxable years 1938 to 1941, inclusive, were more than equal to the amounts distributed in redemption of stock in the latter years.

The petitioner argues that there was a surplus deficit at January 1, 1938, of $175,566.63, due to the prior stock redemptions, which must have been restored out of subsequent earnings before there could have been any earnings available for dividends.

That argument is not in conformity with any opinion expressed by the Circuit Court and, moreover, it is contrary to the law. It has been repeatedly held that "deficits" resulting from stock redemptions over and above the earnings and profits, as distinguished from deficits resulting from operating losses, constitute an impairment of capital which does not have to be restored before there can be earnings available for dividend distributions. See *Van Norman Co. v. Welch* (C.C.A., 1st Cir.), 141 F.2d 99; *F. W. Henninger,* 21 B.T.A. 1235; *Stanley M. Bolster, Executor,* 23 B.T.A. 347; and *Mercantile Bridge Co.,* 2 T.C. 166.

In the *Van Norman Co.* case, *supra,* the court said:

" . . . For tax purposes only impairments of capital caused by losses must be restored out of subsequent earnings before there can be accumulated earnings or profits available for dividends and 'Of course, accumulated earnings or profits available for dividends are not to be diminished in order to restore an impairment or reduction of capital caused by distribution therefrom as distinguished from losses.' . . . "

We hold, as in our prior opinion, that the amounts distributed to the petitioner in the taxable years 1938 to 1941, inclusive, in redemption of shares of preferred stock were made at such

time and in such manner as to be essentially equivalent to distributions of taxable dividends.

Decision will be entered for the respondent.

Note

See "Stock Redemptions in Close Corporations: A Plan for Taxation," 67 Yale L.J. 112 (1957).

For consideration of related problems under the 1954 Code, see Stinson, "Some Subchapter C Trouble Spots—After Two Years," 34 Taxes 890 (1956).

Redemption of Stock to Pay Death Taxes

An important qualification of sec. 302 is found in **sec. 303** which specifically allows capital gain treatment to a redemption made of stock left by a decedent to the extent of death taxes and funeral and administration expenses, subject to the conditions stated in the section.

This provision was first enacted in 1950, as sec. 115(g) (3) of the 1939 Code. It has been refined and liberalized since, most recently at the time of its translation to the 1954 Code.[1]

Is this a desirable provision? Will it open the door for any important tax evasion? Is the 50% limitation desirable? Should it be higher?—or lower? Is the provision as written confined to "family" corporations? Would it be applicable where the decedent put more than 50% of his assets into General Motors stock or some other "public" corporation? Are there possible difficulties here?

Redemption Through Use of Related Corporations

In *Commissioner v. Trustees of Wanamaker Trust,* 178 F.2d 10 (C.A.3d, 1949), it appeared that T owned all the stock of X corporation, and that X corporation owned all the stock of Y corporation. Y purchased from T a portion of the stock which T held in X. If X had purchased the stock from T, this would clearly have been taxable under sec. 115(g). It was held that the purchase as carried out was not within the statute.[2]

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1 For discussions of this provision, see Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 236–238; Winton, "New Difficulties for Estates—Evaluation of Stock under Section 115(g)(3)," 31 Taxes 204 (1953); Simons, "Redemption of Stock to Pay Death Taxes," 29 Taxes 139 (1951).

2 There is a comment on the case in 63 Harv.L.Rev. 1276 (1950). See also Propp, "The Wanamaker Case—Loophole or Noose?" 5 Tax L.Rev. 575 (1950).

This result was changed by a provision first enacted in 1950 as sec. 115(g)(2) of the 1939 Code. This has now been extended and carried forward into **sec. 304** of the 1954 Code. As first enacted, the provision was applicable only where the stock of a corporation was acquired by a subsidiary which it controlled. In the 1954 Code, it is also applicable to what the Committee Reports call "brother-sister corporations." This relates to situations where one or more persons are in control of each of two corporations, and one of the corporations acquires stock of the other.[2]

Does the statute yet go far enough? Should there be a provision extending the same rule where a parent acquires previously outstanding stock in a subsidiary? Is this really a parallel situation? Will stock acquired under the conditions of sec. 304 always be taxable as a dividend, where there are adequate earnings and profits? Suppose, for example, that a shareholder sells all of his stock to a subsidiary. Is there anything in sec. 304 which prevents this from being treated as a partial liquidation? See, generally, Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 234–236.

D. LIQUIDATING DISTRIBUTIONS[3]

Secs. 331–346 of the 1954 Code

There is one point that is clear about liquidating distributions. Distributions in *complete* liquidation are in exchange for the stock, and produce capital gain or loss. This is expressly provided by sec. 331(a)(1) of the 1954 Code (formerly found in sec. 115(c) of the 1939 Code), and there is ordinarily little difficulty in telling whether a distribution is in complete liquidation.

Except in special situations, this is true regardless of the amount of the corporation's earnings and profits at the time of liquidation. This rule was established in *Hellmich v. Hellman,* 276 U.S. 233 (1928). It is interesting to note that in this case it was the Government which argued that the gain was capital gain rather than a dividend. The tax year involved was 1919, and at that time capital gains were taxable in full, while dividends were subject to surtaxes only, and not to normal tax.

Should the law provide that gain on a corporate liquidation is taxable as a dividend to the extent of the shareholder's pro rata proportion of the corporation's earnings and profits? This is the law in Canada.

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2 See Rev.Rul. 55–15, 1955–1 Cum.Bull. 361, where such a transaction was held to be a dividend under the 1939 Code.

3 See Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 214–223, 255–299; Cohen, Gelberg, Surrey, Tarleau and Warren, "The Internal Revenue Code of 1954; Corporate Liquidations," 55 Col.L.Rev. 37 (1955).

The principal problems with respect to liquidating distributions relate to distributions which are contended to be in partial liquidation. The statutory provision (sec. 331(a)(2)) is equally clear here; but it is much more difficult to tell whether a particular distribution is one in partial liquidation, or is one which involves a cancellation or redemption of stock which is essentially equivalent to a taxable dividend, and thus taxable as a dividend under sec. 302.

COMMISSIONER v. SULLIVAN

United States Court of Appeals, Fifth Circuit, 1954. 210 F.2d 607.

HOLMES, CIRCUIT JUDGE. These appeals involve income taxes for the calendar year 1943. They are in consolidated proceedings and were taken by the Commissioner from decisions of the Tax Court entered on August 11, 1952. . . . Error is assigned on the part of the Tax Court in holding that certain distributions in kind were not essentially equivalent to a taxable dividend within the meaning of Section 115(g) of the Internal Revenue Code, but that such distributions were taxable as in partial liquidation of the corporation as provided in Section 115(c) of said code.

The Texon Royalty Company, a Delaware corporation, made a distribution in kind on April 1, 1943, to its two sole stockholders in cancellation of 2,000 shares, or two fifths, of its capital stock. The income tax deficiencies asserted against the husbands of the two stockholders resulted from the fact that the tax returns of each couple were filed in accordance with the community property laws of Texas, in which state all parties resided. The question presented here is whether the redemption and cancellation of the stock was at such time and in such manner as to make the distribution essentially equivalent to a taxable dividend so as to be taxable to the recipients to the extent of Texon's accumulated earnings and profits, instead of being treated as payment in exchange for the stock and subject only to a capital gains tax. In other words, was the distribution taxable under Section 115(g) or 115(c) of the Internal Revenue Code?

The Tax Court held that Section 115(g) was inapplicable and, therefore, that the taxpayers' entire gain on the distribution was taxable as a long-term capital gain. This holding was based primarily upon findings of fact, in substance as follows: Texon held a great many producing oil leases outside of the Agua Dulce oil field, which was a high pressure field. A suit for damages from a blowout which occurred in prior operations in that field was pending against Texon at the time of the distribution. The leases transferred needed to be developed, and they were trans-

ferred because Texon did not want to take the risk of developing them and because it did not have authority under its charter to drill wells. The same reasons prompted the distribution of its drilling equipment. Another reason was that this equipment could be used in the development of the oil properties transferred. The gas payment and the notes were included in the distribution in order to furnish the distributors with additional capital or credit to aid them in the development of the properties transferred, which was undertaken soon after the distribution. The drilling equipment was transferred by the stockholders to a corporation in connection with the development. The avoidance of taxes was not one of the reasons for the distribution.

The petitioner argues that, if the redemption of stock is made pro rata, any business purpose for the redemption thereof will usually be outweighed by the net effect of the transaction. The respondents contend that the Tax Court has weighed the evidence in this case with regard to the net effect of the transaction as well as to the business purposes of the corporation, and has found that the distribution was dictated by the reasonable needs of the corporate business, not merely to benefit the stockholders by giving them a share of the earnings of the corporation.

The Tax Court's opinion expressly refers to its considering the net effect of the transaction; and we cannot say that it used the wrong test, or that there was any specific test for the issue before it. We agree that the pro rata redemption of stock will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits, but to hold that this is always true would nullify the regulation which sanctions it in some cases and says that the question depends upon the particular circumstances of each case. See Treasury Regulations 111, Secs. 29.115–5 and 29.115–9.

The so-called net-effect test is not a weighted formula by which to solve the issue before the court. The net effect of the transaction is not evidence or testimony to be considered; it is an inference to be drawn or a conclusion to be reached. It is not a solvent but a residuum; it is not a process but a product; it is not a means but an end; it is not a solution but a restatement of the statutory provision; it is the gist of the governing law of the case; it is not a balance for weighing the law against the facts; it is the law itself. "Net effect" is a paraphrase for "essentially equivalent." It is just as if the statute read: "If a corporation redeems its stock in whole or in part, so that the net effect of the transaction is the same as the payment of a taxable dividend, the amount so distributed shall be treated as a taxable dividend." The net-effect test is not a test but an attractive abbreviation of the statute, as to which we shall be on safer ground if we stick to the words of the statute: essentially equivalent.

The distribution of the high-pressure leases and the drilling equipment constituted a contraction of Texon's business. When there is a contraction or shrinkage of corporate business, the need of a corporation for funds to carry on its former activities is largely eliminated. Following a contraction of its activities, and with surplus funds on hand, good business and accounting practices dictated a redemption of a portion of the corporation's capital stock. Failure to reduce its capital would have resulted in the payment of unnecessary capital-stock taxes contrary to good business practices. There were other factual considerations that entered into the decisions of the Tax Court.

Strong as is the pro-rata factor in this case, it is not sufficient in itself to require or authorize us to set aside the findings of the Tax Court and invoke the application of Section 115(g). To do so would nullify the regulation that authorizes the complete retirement of any part of the stock, whether or not pro rata among the shareholders. In a number of cases, in applying the so-called net-effect test, some of which held the distribution taxable, the courts have called attention to the fact that there was no purpose on the part of the taxpayer to contract its business or narrow the scope of its operations. In *Flanagan v. Helvering,* Justice Vinson (later Chief Justice of the United States) said: "The corporation did not manifest any policy of contraction". 73 App.D.C. 46, 116 F.2d 937, 939. See also *Commissioner v. Babson,* 7 Cir., 70 F.2d 304; *Hyman v. Helvering,* 63 App.D.C. 221, 71 F.2d 342; *Commissioner v. Champion,* 6 Cir., 78 F.2d 513; *Smith v. United States,* 3 Cir., 121 F.2d 692; *Hirsch v. Commissioner,* 9 Cir., 124 F.2d 24; *Rheinstrom v. Conner,* 6 Cir., 125 F.2d 790; *Vesper Co. v. Commissioner,* 8 Cir., 131 F.2d 200; *Commissioner v. Snite,* 7 Cir., 177 F.2d 819; *Boyle v. Commissioner,* 3 Cir., 187 F.2d 557; *Commissioner v. Roberts,* 4 Cir., 203 F.2d 304; *Upham v. Commissioner,* 4 T.C. 1120; *Imler v. Commissioner,* 11 T.C. 836; *O'Brian v. Commissioner,* Par. 51,373 P–H Memo T.C., 1141.

The decisions of the Tax Court are affirmed.

Affirmed.

RIVES, CIRCUIT JUDGE (dissenting). . . . The Regulations make it clear that the fact that the cancellation or redemption of stock is pro rata is the most important single fact tending to show essential equivalence to the distribution of a taxable dividend. A pro rata redemption of stock does not change the stockholders' proportionate interests in and control over the corporation and is usually a mere formality. It seems to me utterly immaterial whether each of the two stockholders owned 1500 shares, as before the distribution, or 2500 shares, as after the distribution. They each owned fifty percent of the stock both before and after

the distribution. Their interests in and control over the corporation were not affected in any way. . . .

The only real reasons suggested for the redemption of stock were to reduce capital stock taxes, usually a very small factor, and to accord with good business and accounting practices. If those reasons were really substantial, they did not call for any liquidation, even partial, of the corporation, but merely for a simple amendment of the corporate charter. A mere change in capital structure is not, in and of itself, a legitimate business reason for the redemption of stock. Bazley v. Commissioner, 331 U.S. 737.

It seems to me that the law is clearly to the effect that the actual conduct of the parties and the objective results of the distribution and redemption of stock, rather than any business motives, needs or purposes, furnish the controlling factors for the application *vel non* of Section 115(g). Whatever may have been the mental ratiocinations of the two stockholders and the assumed business purposes and needs of the corporation, their conduct and the results thereof were "essentially equivalent to the distribution of a taxable dividend." Their acts seem to me more important taxwise than their intentions.

I, therefore, respectfully dissent.

Notes

Pro Rata Distributions

(A) Where there is a distribution which is pro rata among the shareholders, the courts are very likely to find that there has not been a partial liquidation. The principal case should not be regarded as typical, although there are facts there which support the result. The most important factor to support a claim of partial liquidation is a definite contraction in the scope of the corporation's business. Thus, in *Joseph W. Imler,* 11 T.C. 836 (1948), the court found that there was a bona fide contraction of business operations because of a fire and war-time conditions. It held that a pro rata redemption of shares from the three shareholders was a partial liquidation, and not taxable as a dividend under the former sec. 115(g).[1]

This matter is now affected by the provisions of sec. 346(b) of the 1954 Code. It is clear, however, that this is not exclusive.

[1] For discussions of the problems, generally, see Bittker, "Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954," 9 Stanford L.Rev. 13 (1956); Bernbach, "Substantially Disproportionate Redemptions Under the 1954 Act," 33 Taxes 597 (1955); Blawie, "Some Tax Aspects of a Corporate Liquidation," 7 Tax L.Rev. 481 (1952); Bittker and Redlich, "Corporate Liquidations and the Income Tax," 5 Tax L.Rev. 437 (1950); Murphy, "Partial Liquidations and the New Look," 5 Tax L.Rev. 73 (1949); "Taxation of Distribution in Partial Liquidation of Corporations," 55 Harv.L. Rev. 835 (1942); Darrell, "Corporate Liquidations and the Federal Income Tax," 89 U. of Pa.L.Rev. 907 (1941); "Income Taxation of Liquidating Dividends," 47 Yale L.J. 1146 (1938).

The Committee Reports state that "a genuine contraction of the business . . . will result in a partial liquidation. . . . However, a distribution of a reserve for expansion is not a partial liquidation." See Chommie, "Section 346(a)(2): The Contraction Theory," 11 Tax L.Rev. 407 (1956).

Cancellation of All the Stock of One Shareholder

(B) The statute now expressly provides that the "redemption of all the stock of the corporation owned by the shareholder" shall be treated as a payment in exchange for the stock, thus resulting in a capital gain or loss. Sec. 302(b)(3) of the 1954 Code. This rule has long been provided in the Regulations. See sec. 39.115–9 of Regulations 118. In 1951, the Treasury indicated its intention to modify this regulation, but no final step was taken. As indicated, the matter is now covered by the statute.

Note, however, the substantial restriction contained in sec. 302(c)(2). Under this, the shareholder's separation from the corporation must be relatively final and complete.

The interrelation between sec. 302 and sec. 346 are far from clear. The Senate Committee Report states that "distributions in redemption of stock which qualify as distributions in complete or partial liquidation under Part II of subchapter C [which includes sec. 346] are not within the scope of sec. 302." Just what the effect of this is may require some elucidation.

(C) Consider a situation like that involved in the *Roberts* case, set out at p. 678, above. A and B own all the stock of a corporation. B dies and his will leaves all his stock to A. While the stock is still in the hands of B's executor (and under circumstances which do not come within sec. 303), B's stock is redeemed by the corporation. Is this a partial liquidation within sec. 302(b)(3) or sec. 346, or would the rule of the *Roberts* case apply? Consider sec. 318(a)(2)(A), made applicable by sec. 302(c)(1), but perhaps made inapplicable by sec. 302(c)(2). Rev.Rul. 56–103, 1956–1 Cum.Bull. 159, holds this to be a dividend.

(D) A woman owned all the stock of a corporation. It had substantial earnings and profits. She sold part of her shares to X. Shortly thereafter, the corporation cancelled and redeemed all of her remaining shares. It was held that this was a partial liquidation, taxable at capital gain rates, and not taxable under the former sec. 115(g). *Zens v. Quinlivan,* 213 F.2d 914 (C.A. 6th, 1954). The Treasury has accepted this decision, but says that all such cases will be carefully scrutinized. Rev.Rul. 54–458, 1954–2 Cum.Bull. 167.

Would this result follow under the present statute? See Rev. Rul. 55–745, 1955–2 Cum.Bull. 223.

The transaction in the *Zens* case was successful. But suppose that all of the stock had been sold for $100,000, under an arrangement where the buyer paid $90,000, and the corporation then distributed $10,000 of "unwanted assets" to the seller. This has been held to be a dividend to the buyer, since it relieves him of his obligation to pay the balance of the purchase price to the seller. *Frithiof T. Christensen,* 33 T.C. 500 (1959).

Or suppose that the unwanted assets are distributed to the seller, and he then sells his shares to the buyer. This will be a

dividend to the seller. Compare *Mayer v. Donnelly,* 247 F.2d 322 (C.A.5th, 1957), where the distribution was made to the seller after title to the shares had passed to the buyer. This was held not a dividend to the seller, but a part of the purchase price. It would seem to follow that it was a dividend to the buyer.

So the form of the transaction in this situation can be of great importance, and is a factor to be taken carefully into account in planning any transaction of this sort.

In *Zipp v. Commissioner,* 259 F.2d 119 (C.A.6th, 1958), *cert. den.,* 359 U.S. 934 (1959), *affirming per curiam* 28 T.C. 314 (1957), where a father owned 48 shares, and his two sons one each, the redemption of the father's stock was held to be a dividend to the sons. However, a contrary result was reached in *Holsey v. Commissioner,* 258 F.2d 865 (C.A.3d, 1958), where one of two equal shareholders acquired an option to purchase all of the stock of the other owner, assigned it to the corporation, and had the latter immediately exercise the option by redeeming the stock. Circuit Judge Maris there stated for the majority (258 F.2d at 868–869):

"The question whether payments made by a corporation in the acquisition and redemption of its stock are essentially equivalent to the distribution of a taxable dividend has been often before the courts and certain criteria have been enunciated. The most significant of these is said to be whether the distribution leaves the proportionate interests of the stockholders unchanged as occurs when a true dividend is paid. *Ferro v. Commissioner of Internal Revenue,* 3 Cir.1957, 242 F.2d 838, 841. The application of that criterion to the facts of this case compels the conclusion that in the absence of a direct pecuniary benefit to the taxpayer the Tax Court erred in holding the distribution in question taxable to him. For in his case prior to the distribution the taxpayer and the Greenville Company each had a 50% interest in the Holsey Company whereas after it was over the taxpayer had 100% of the outstanding stock and the Greenville Company none.

"The Government urges the lack of a corporate purpose for the distribution and the taxpayer seeks to establish one. But we do not consider this point for, as we have recently held, 'It is the effect of the redemption, rather than the purpose which actuated it, which controls the determination of dividend equivalence.' *Kessner v. Commissioner of Internal Revenue,* 3 Cir. 1957, 248 F.2d 943, 944. Nor need we discuss the present position of the Government that the transaction must be treated as a sham and the purchase of the stock as having been made by the taxpayer through his alter ego, the Holsey Company. For the Tax Court made no such finding, doubtless in view of the fact that at the time the taxpayer owned only 50% of the stock and was in a minority on the board of directors. On the contrary, that court based its decision on the benefit which the distribution by the corporation to the Greenville Company con-

ferred upon the taxpayer, which it thought gave rise to taxable income in his hands.

"For the reasons stated we think that the Tax Court erred in its decision." [1]

Compare the problem of the partnership buy-sell arrangement, where there is an arrangement that on the death of a partner, the survivor or survivors, or the partnership will buy the decedent's shares. See, for example, *Henry E. Prunier,* 28 T.C. 19 (1957), reversed in *Prunier v. Commissioner,* 248 F.2d 818 (C.A.1st, 1957). See also Friedman and Wheeler, "Stock Redemption Agreements Funded by Life Insurance," 37 Taxes 915 (1959); Swados, "Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement," 26 Fordham L.Rev. 189 (1957); Steinberg, "Funding Stock Redemption Agreements with Life Insurance," 35 Taxes 669 (1957).

Liquidation Followed by Reincorporation

Suppose a corporation has a large cash balance, along with assets actively used in the trade or business. It has large earnings and profits, so that if the cash is distributed to the shareholders it is likely to be a dividend. In this situation, it carries out a complete liquidation. Following the liquidation, the shareholders retain the cash, and transfer the business assets to a new corporation which continues the operation of the business.[2]

Is this a way to get the cash out at capital gain rates?

Cf. *Liddon v. Commissioner,* 230 F.2d 304 (C.A.6th, 1956), where the court held that such a transaction was a "reorganization" under the statute, with the cash received being taxable as "boot" under what is now sec. 356 of the 1954 Code. See pages 753–757, below.

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1 For a thorough discussion of this problem, see Lanning, "Tax Erosion and the 'Bootstrap Sale' of a Business," 108 U. of Pa.L.Rev. 623 (1960); Hawkins, "Dividend Consequences of Stock Redemptions to Remaining Stockholders," 37 Texas L.Rev. 729 (1959); Singer, "Tax Consequences of Stock Redemptions For Shareholders Whose Stock is Not Redeemed," 38 Ore.L. Rev. 1 (1958). See also Jones, "How Stock Redemptions Produce Dividend Income," 36 Taxes 437 (1958); Graham, "Redemption Problems—The *Holsey* and *Zipp* Cases," 36 Taxes 925 (1958); Buschmann and Carr, "The Corporate Buy-and-Sell Agreement," 45 A.B.A.J. 292, 293–94 (1959); Smith, "Recent Developments in the Field of Corporate Business Purchase Agreements," 14 Tax L.Rev. 413, 417–22 (1959); Comment, 57 Mich.L.Rev. 578 (1959); Notes, 72 Harv.L.Rev. 776 (1959); 12 Vand.L.Rev. 505 (1959).

2 See Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 262–263, 399–401; Grubb, "Corporate Manipulations under Subchapter C: Reincorporation-Liquidation," 28 Cinn.L.Rev. 304 (1959); Rice, "When Is a Liquidation Not a Liquidation for Federal Income Tax Purposes?" 8 Stanford L.Rev. 208 (1956); Bakst, "Does Dissolution Followed by Reincorporation Constitute a Reorganization?" 33 Taxes 815 (1955).

BERETTA v. COMMISSIONER

United States Circuit Court of Appeals, Fifth Circuit, 1944. 141 F.2d 452.

WALLER, CIRCUIT JUDGE. The taxpayer was a stockholder in the Laredo Bridge Company, a Texas corporation, which owned and operated a toll bridge across the Rio Grande River between the cities of Laredo, Texas, and Nuevo Laredo, Mexico. As of March 31, 1922, the capital stock of the company was $250,000, with a surplus in excess of $259,000. In April, 1922, the capital stock of the company was increased to $500,000 by the declaration of a 100% stock dividend to the stockholders of record. The par value of the shares was $100. The stock dividend was treated as a non-taxable transaction, by which the capital stock was increased to $500,000 and the surplus reduced to approximately $10,000.

The bridge was constructed under a concession from the Mexican Government and under a permit or franchise from the City of Laredo, Texas. The concession from Mexico contained a provision that at the end of fifty years the Mexican portion of the bridge should become the property of the government of Mexico upon the payment to the company of two-thirds of its then appraised value. This franchise expired June 26, 1937, and Mexico took over that end of the bridge in accordance with the terms of the franchise, and on July 24, 1937, paid the Bridge Company $75,962.28. On June 15, 1937, the directors of the corporation, after having voted to declare two two-percent cash dividends out of surplus earnings, also passed the following resolution:

"Resolved, that the Treasurer be, and hereby is, authorized to distribute to Stockholders of record as of June 7, 1937, substantially all of the net proceeds of the sale of the Mexican end of the bridge on receipt of payment from the Mexican Government."

But on September 14, 1937, the directors met again, at which time the Treasurer reported that the sale of the Mexican end of the bridge had resulted in a net loss to the capital of $68,630.53, which, together with the cash dividend previously voted but not yet paid, would result in the impairment of the capital stock of the company in the sum of $62,388.48. Nevertheless, the directors voted to distribute to the stockholders the sum of $135,000, representing the sum received from the sale to the Mexican Government, and a portion of the sum reserved for depreciation attributable to the end of the bridge which it no longer owned. At a special meeting of the stockholders, called for the purpose of authorizing the stock to be reduced from $500,000 to $250,000, the following resolution was passed:

"Be It Resolved, that the action of the Board of Directors of Laredo Bridge Company on September 14, 1936, authorizing the

Treasurer to make a capital distribution of Twenty-seven per cent on September 30, 1937, to the Stockholders of record on September 27, 1937, be and hereby is, approved and ratified.

"Be It Resolved, by the Stockholders of Laredo Bridge Company that the capital stock of this corporation be, and the same hereby is, decreased from Five Thousand Dollars [sic] ($500,000.00) to Two Hundred Fifty Thousand Dollars ($250,000.00); and the Board of Directors of this corporation is hereby authorized and directed to execute and file with the Secretary of the State of Texas an amendment to the charter of this corporation, and to take such other action as is necessary to make such decrease in the capital stock effective."

An appropriate amendment to the charter was approved by the Secretary of State of Texas on October 23, 1937, for the reduction of capital stock.

Taxpayer and wife, reporting income on the community basis, received $27,706 of the $135,000 so distributed, but did not report it as taxable income. Taxpayers also received, and duly reported as income, their proportionate part of the cash dividends declared by the company.

The taxpayer contends that the $135,000 distribution by the company was a capital distribution made in partial liquidation of the corporation under Sections 115(c) and (i) of the Revenue Act of 1936.

The Commissioner contended that the distribution was not in partial liquidation because: (1) the corporation did not cancel nor redeem any part of its stock but merely reduced the par value of its shares; (2) the dividend was out of profits accumulated after February 28, 1913, and since the original increase in capital stock by the 100% stock dividend was out of earnings and profits the distribution here would be deemed to be out of earnings and profits, to be treated as income for tax purposes. The Tax Court sustained the Commissioner and we are asked to review the decision.

The first question to be determined is whether or not the dividend of $135,000 by the corporation to its stockholders was a distribution in partial liquidation. Section 115(i) defines partial liquidation as "a distribution by a corporation in complete cancellation or redemption of a part of its stock." In the present case the par value of the shares of stock was reduced from $100 to $50 and a notation to that effect was stamped upon each certificate of stock, but no share of stock was cancelled completely. We must, therefore, determine whether or not the $135,000 distribution and the attendant reduction of each share of stock from $100 to $50 resulted in the complete cancellation or redemption of a part of the stock and was a partial liquidation under said Section. . . .

In the present case there is no substantial evidence that the distribution was made with the intent to wind up, or to initiate a process of winding up, the affairs of the corporation. The Bridge Company was a going and profitable concern, still owning one-half, or more, of a valuable public utility, with a public duty to operate it. A partial reduction of a corporate liability is not ordinarily a partial liquidation of the corporation. In the absence of proof of an affirmative intent to wind up its affairs and to completely cancel a portion of its stock, all that the corporation here accomplished was a reduction of its capital stock with a concomitant and ratable reduction of its liability to its stockholders thereon. Even though the par value of each share of stock was reduced from $100 to $50 not a single share was completely canceled. The actual value of stock may be far in excess of its par value. The corporation's liability to its stockholders is not measured by the par value of its shares, but by the value of its net assets, which in liquidation must be ratably distributed to its outstanding shares. Even though a 27% dividend resulted in a 50% reduction in par value of its outstanding stock, the actual value of the stock was not necessarily reduced 50%, but each stockholder still had the same percentage of ownership and would receive in final liquidation the same ratio, of the corporate assets, distributable to its stockholders, as if the 27% distribution had not been made. No stock was canceled so as to permit each remaining share to receive a larger proportion in future distributions of the remaining assets. The distinction between a partial liquidation where stock is completely canceled and a diminution of capital by a mere reduction in par value of all outstanding shares is thus clearly demonstrated.

A reduction in par value of capital stock upon a pro rata payment to each stockholder without an intent to wind up its affairs does not render such payment a distribution in partial liquidation, and in the absence of such intent and in the absence of the complete cancellation or redemption of a part of the stock by such payment the payment is taxable as income. *Wilcox v. Commissioner of Internal Revenue*, 9 Cir., 137 F.2d 136.

Moreover, the Tax Court held that the entire $135,000 paid to the stockholders was a dividend out of earnings and profits, notwithstanding the recitals in the resolution of the directors that a portion thereof was the reserve for depreciation for that portion of the bridge which was sold to Mexico, and a portion was from the sale, at a loss, of a capital asset. The basis for this holding was that the $250,000 stock dividend, declared in 1922, was out of earnings and profits which had been accumulated since February 28, 1913, and that when the corporation, during the tax year here, reduced its capital stock by $250,000 the amount of its earnings which were capitalized in 1922 should

have been included in the computation to the extent that they represent earnings or profits since February 28, 1913. In this manner the distribution would not result in impairment of capital, nor in the distribution of capital assets and reserves for depreciation. Where a corporation has available sufficient earnings and profits any distribution to stockholders will, for tax purposes, be deemed to have been made from its earnings and profits instead of from capital assets or reserves for depreciation. Sec. 115(b), Rev.Act 1936.

A corporation may not completely avoid tax consequences to its stockholders by declaring a stock dividend out of profits in one year, later reducing its capital stock by the amount of such stock dividend, and then distributing, as capital assets, these profits under the guise of a partial liquidation. *Walker v. Hopkins, Collector,* 5 Cir., 12 F.2d 262; *Eisner v. Macomber,* 252 U. S. 189.

The Tax Court was right in both features of this case, viz., (a) the distribution was not one in partial liquidation; (b) the distribution will be deemed to have been made from the profits represented in the 1922 stock dividend, instead of from capital assets or reserves for depreciation.

The decision is affirmed.

SIBLEY, CIRCUIT JUDGE, dissents.

Notes

Liquidation of a Corporate Subsidiary

(A) Under **sec. 332** of the 1954 Code no gain or loss is realized by a corporation on the liquidation of another corporation of which it owns at least 80% of the stock. This carries forward a provision which has long been found in sec. 112(b)(6) of the 1939 Code. See Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 272–282.[1]

(B) A Corporation owns all of the outstanding stock of B Corporation, which consists of both preferred stock and common stock. B's assets are distributed, and there is not enough available to pay off the preferred stock in full. The Second Circuit has held that the loss on the common stock is deductible. This is not a liquidation under sec. 112(b) (6) of the 1939 Code, now found in sec. 332 of the 1954 Code. *Commissioner v. Spaulding*

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[1] For consideration of the problems under this provision, see Friedman, "All Cash Distributions under Section 112(b)(6)," 8 Tax L.Rev. 369 (1953); Whitaker, "Section 112(b)(6): Benefit or Burden?" 7 Vanderbilt L.Rev. 93 (1953); Colgan and Molloy, "Tax-Free Liquidations of Corporate Subsidiaries under Section 112(b)(6) of the Internal Revenue Code," 4 Tax L.Rev. 305 (1949); Busterud, "The Liquidation of Subsidiaries under Section 112(b)(6)," 58 Yale L.J. 1050 (1949); Stuetzer, "Upstream Debts in Section 112(b)(6) Liquidations," 5 Tax L.Rev. 199 (1950); Mannix, "Liquidation of Newly Acquired Subsidiaries," 26 Taxes 1112 (1948).

Bakeries, Inc., 252 F.2d 693 (C.A.2d, 1958). The decision of the Tax Court, to the same effect, was noted in 70 Harv.L.Rev. 1479 (1957).

(C) *Basis.* **Sec. 334(b)** provides the rule for the basis of the property received in such liquidations. Ordinarily, where such intercorporate liquidations occur, the basis of the property to the distributee is the same as it was in the hands of the transferor. Sec. 334(b)(1). This may present a barrier to such liquidations, as the basis to the parent corporation of its stock may be much more than the basis of the assets held by the subsidiary, particularly after an unsuccessful business operation.

However, the 1954 Code introduces a new provision, intended to codify the rule of *Kimbell-Diamond Milling Co. v. Commissioner,* 187 F.2d 718 (C.A.5th, 1951). In that case, it appeared that X corporation bought all the stock of Y Corp. Its sole purpose was to acquire a flour mill owned by Y, to replace one destroyed by fire. Y was liquidated five days after the stock was acquired, and X thus became the owner of the flour mill and of the other assets owned by Y. The court held that the transaction was in substance a purchase of assets by X, and that the basis of the assets to X was the amount it had paid for the stock and not their basis to Y.

To the same effect is *Kanawha Gas & Utilities Co. v. Commissioner,* 214 F.2d 685 (C.A.5th, 1954). See also *United States v. M. O. J. Corp.*, 274 F.2d 713 (C.A.5th, 1960), where it was held that the rule applies even though the purpose was to acquire the whole business of the purchased corporation, rather than some particular asset.

Under **sec. 334(b)(2),** if its conditions are complied with, the basis of the assets received on such a liquidation will be the same as the basis of the stock, which will ordinarily be the cost of the stock. Note that this is applicable only in case of a complete liquidation, carried out within the period prescribed by the statute.[2]

(D) Section 334(b) of the 1954 Code applies only to liquidations by a corporate shareholder. How far, then, does the *Kimbell-Diamond* principle remain in effect as to individuals? If an individual buys stock for the purpose of getting an asset, does he have gain or loss on the liquidation of the corporation if the asset at the time of liquidation is worth more or less than he pays for the stock?

This question was involved in *Ruth M. Cullen,* 14 T.C. 368 (1950), in which the Commissioner has acquiesced, 1950–2 Cum. Bull. 1, and in *H. B. Snively,* 19 T.C. 850 (1953). In the *Cullen* case, the taxpayer bought all the stock of a corporation in order to liquidate it and operate the business as a sole proprietorship. He paid substantially more for the stock than the fair market value of the assets. The Court held that the purchase of the

[2] See Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 281–282. For consideration of a special problem, see Weingarten, "Installment Obligations in a Kimball-Diamond Type Liquidation," 34 Taxes 532 (1956).

stock and the liquidation of the corporation were in substance a purchase of the corporation's assets, from which the taxpayer realized no capital loss.

In the *Snively* case, the taxpayer bought all the stock of a corporation whose primary asset was a citrus grove. The stock was purchased for the purpose of acquiring the grove, and the corporation was dissolved and its assets distributed five months after the purchase. The fair market value of the grove was in excess of the price paid for the stock. The Court held that the taxpayer realized no taxable gain on the liquidation of the corporation. *United States v. Mattison*, 273 F.2d 13 (C.A.9th, 1959), is to the same effect.

In each case, the basis of the property to the taxpayer would be the same as his cost for the stock.

Do these cases survive the enactment of Section 334(b)? Does that provision, dealing only with corporate liquidations, have any relation to liquidations by individuals?

Elective Method of Treating Complete Liquidations

(E) **Sec. 333** of the 1954 Code provides an elective method for treating the gain on a complete liquidation of a domestic corporation. (This corresponds to sec. 112(b)(7) of the 1939 Code, which was a temporary provision; the provision in the 1954 Code is permanent.)

Under this provision, if the shareholders elect, the gain is recognized, and taxed as a dividend, to the extent of the shareholder's share of the earnings and profits of the corporation. Any additional gain is not recognized, but the property is taken over at the basis which the shareholder had for his stock. Sec. 334(c). Thus, in effect, unrealized appreciation in value of property held by the corporation is not presently taxed. The general purpose of this provision is to allow a reasonably attractive means for the liquidation of personal holding companies. For discussion, see Eaton, "Liquidation under Section 112(b)(7)," 38 Va.L.Rev. 1 (1952).

In *Meyer's Estate v. Commissioner*, 200 F.2d 592 (C.A.5th, 1952), the shareholders elected to be taxed under the former sec. 112(b)(7), signifying their election within the time provided in the regulations. They believed that the corporation had only a small amount of earnings and profits. Actually, because of certain mergers that had occurred, the earnings and profits were very large, and the ordinary tax on a complete liquidation would have been much more advantageous. Although the regulation expressly provides that an election "cannot be withdrawn or revoked," the court held that the election was ineffective, being based on a mistake, and could be withdrawn.

(F) *Liquidation of foreign personal holding company.* Sec. 342 provides that the liquidation of a foreign personal holding company will result in *short term* capital gain. Sec. 342(b) gave a brief period during which a foreign personal holding corporation could be liquidated at capital gain rates. This expired on January 1, 1956.

Collapsible Corporations

Sec. 341 contains special provisions relating to "collapsible corporations." This carries forward a provision found in sec. 117 (m) of the 1939 Code, first enacted in 1950.

This provision of the statute was designed primarily to get at three types of situations, which may be summarized as follows:

(1) A group of people (actors and producers) get together, put up a small amount of money, agree to accept relatively small salaries, and make a motion picture through a corporation which they organize and in which they own the stock. When the picture is completed (at which time, if the picture is successful, it is worth a considerable sum), the corporation is liquidated. Or, the picture may be distributed to the shareholders, since the corporation has no earnings, and the corporation can then be continued in existence to carry out a new venture. It was hoped that the gain would be taxable to the shareholders as capital gain, and that the shareholders would not be taxable on royalties from the picture until they exceeded the value of the picture at the time of liquidation.

(2) A company engages in a housing construction project. When the houses have been built, and have a fair market value in excess of cost, the company is liquidated, or its shares sold, or the houses are distributed to the shareholders. It was hoped that the gain from the construction activity would thus be taxable as a long term capital gain.

(3) A person or a company has inventory property which has greatly appreciated in value. It transfers the inventory property to a new corporation in exchange for its stock, and then sells the stock. It was hoped that the inventory gain would thus be translated into a capital gain.

This list is not exhaustive, but it is sufficient to show the general nature of the problem to which the collapsible corporation provisions are directed. Suppose, for example, that a lawyer has a large outstanding fee. He organizes a corporation, and transfers the claim for the fee to the corporation in exchange for the stock. Then he sells the stock. Could he thus convert the fee into a capital gain?

Under sec. 341, gain derived in cases of these sorts, either through sale or on distributions from the corporation, is treated as gain from the sale of property which is not a capital asset. Thus, the gain is taxable at ordinary income rates. It is not even

available to be offset by capital losses. For general consideration, see Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 299–320.[3]

GLICKMAN v. COMMISSIONER

United States Court of Appeals, Second Circuit, 1958. 256 F.2d 108.

SWAN, CIRCUIT JUDGE. . . . The issue presented is whether gains realized by each of the taxpayers in 1950 are properly taxable as capital gains, as they claim, or as ordinary income, as the Tax Court held in reliance upon § 117(m) of the Internal Revenue Code of 1939, as amended by § 212 of the Revenue Act of 1950, which relates to "collapsible corporations." The findings of fact and opinion of the Tax Court are reported in T.C.Memo.1957–124.

The facts may be summarized as follows: In February 1949 the taxpayers organized a New York corporation (for brevity hereafter referred to as Mott) for the purpose of constructing an apartment project to be financed by a mortgage loan insured by the Federal Housing Administration (F.H.A.) pursuant to § 608 of the National Housing Act, 12 U.S.C.A. § 1743. Mott acquired vacant land in Far Rockaway, New York, at a cost of $59,000. F. H. A. issued a commitment to insure a mortgage loan to Mott, as intended mortgagee, not to exceed in amount $1,066,500, for the construction of a 126 family apartment project to be known as Bayswater Gardens. Mott obtained the money from the Manhattan Company, and the apartment project was constructed for $55,400 less than the insured mortgage loan. From the time of Mott's incorporation until the taxpayers sold their shares as hereafter mentioned, the taxpayers were the only common stockholders and the only officers and directors of Mott. In January 1950 the directors resolved to write up the value of the corporate property, so as to create a capital surplus on its books, and on January 13 Mott distributed $55,000 in cash to its common stockholders. In the distribution Arthur and Aaron received $13,750 each, and Herman $27,500. The cost basis of their stock was

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[3] See also Bittker, "The Tax Treatment of Collapsible Corporations," 13 Vanderbilt L.Rev. 129 (1959); DeWind and Anthoine, "Collapsible Corporations," 56 Col.L.Rev. 475 (1956); Donaldson, "Collapsible Corporations," 36 Taxes 777 (1958); Axelrad, "Recent Developments in Collapsible Corporations," 36 Taxes 893 (1958); Seidman, "Collapsible Corporations—Application to Real Estate Transactions," 15 Tax L.Rev. 121 (1959).

Modrall, "Collapsible Corporations and Subsection (e)," 37 Taxes 895 (1959), Caplan, "Guides to the 1958 Tax Law for the General Practitioner," 33 Conn. L.J. 344, 358–63 (1958), and Anthoine, "Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment," 58 Col.L.Rev. 1146, 1175–95 (1959), discuss the new subsection (e) of sec. 341. For a discussion of a current proposal for further revision, see Sugarman, "New Concepts Found in Proposed Collapsible Rules," 10 J. of Taxation 273 (1959).

$500 each for Arthur and Aaron, and $1,000 for Herman. All three sold their common shares on August 1, 1950, pursuant to their May 10th contract to sell, at a price which gave Arthur and Aaron $23,411.70 each, and Herman $46,823.39. Mott was not liquidated and its present shareholders operate the project pursuant to F. H. A. regulations and the terms of the mortgage between Mott and the Manhattan Company.

In reaching its decision that the gains realized by the taxpayers, from the cash distribution by Mott and from the sale of their stock should be taxed as ordinary income pursuant to § 117(m), the Tax Court relied upon two of its own prior decisions, *Burge v. Commissioner,* 28 T.C. 246, and *Weil v. Commissioner,* 25 T.C. 809. It considered the Glickman cases indistinguishable from *Burge* in all material respects. *Burge* was subsequently affirmed by the Fourth Circuit, 253 F.2d 765, Judge Parker writing for the court. We are in entire agreement with Judge Parker's opinion. The *Weil* decision was affirmed by the Second Circuit in 252 F.2d 805. These two cases obviate the necessity of lengthy discussion of the petitioners' various contentions which assert that the Tax Court erred in holding Mott to be a "collapsible corporation," as defined in § 117(m).[2]

One of the petitioners' contentions, Point VI of their brief, is that Mott was not a collapsible corporation "because it was not a temporary corporation used to convert ordinary income into capital gain." In support of this contention they refer to the legislative history of the section. It is true that in the discussion of the evils which the statute was intended to prevent, there is frequent mention of cases where liquidation of the corporation occurred; but, as stated by Judge Parker [253 F.2d 769], "it is clear from the committee reports that it was not intended that the legislation be limited to such cases and the act as passed is not so limited." We agree. The statute expressly refutes the idea that the corporate life must be cut short; it taxes "Gain from the sale or exchange (*whether in liquidation or otherwise*) of stock * * *". [Italics added.]

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[2] § 117(m)(2)(A) defines the term as follows:

"(2) *Definitions.*—

"(A) For the purposes of this subsection, the term 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, * * * or for the holding of stock in a corporation so formed or availed of, with a view to—

"(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing * * * the property of a substantial part of the net income to be derived from such property, and

"(ii) the realization by such shareholders of gain attributable to such property."

The applicable Regulation is too long to be quoted, Treasury Regulations 111, § 29.117-11.

In Point IV of their brief the petitioners argue that § 117(m) does not apply to the cash distribution received by them on January 13, 1950. A similar contention was made and overruled in the *Burge* case. It will suffice to say that we are in agreement with the reasons given by the Tax Court and by Judge Parker for rejecting it.

The Tax Court found that the taxpayers' intention to make the cash distribution was formed about January 1, 1950. The petitioners contend that this was too late. They argue that the requisite "view" must exist when the corporation is formed or at least when construction is begun. We agree with Judge Parker's statement in *Burge*: "It is not necessary that the 'view' exist when the corporation is formed. It is sufficient that it exist when the corporation is 'availed of' * * *". Since the corporation may at any time during its corporate life be "availed of" for the proscribed purpose, subject, of course, to the limitations imposed by § 117(m)(3), it seems surprising that the Regulations have adopted a narrower interpretation of the statute, and require the requisite view to exist "during the construction * * *" or to be "attributable" to "circumstances which reasonably could be anticipated by the time of such * * * construction." We are disposed to disagree with so narrow an interpretation, but whether the Regulation is valid need not be determined now. The Tax Court assumed it to be valid, and this assumption, if wrong, was unduly favorable to the petitioners. The court then found that "construction was not completed until some time after the middle of January 1950."

This finding the petitioners say is erroneous because construction was "substantially" completed by December 7, 1949 when the municipal authorities issued their final certificate of occupancy. But we agree that under the correct interpretation of the statute "construction" should be defined technically to mean all construction required to perform the contract completely.[3] Concededly something remained to be done after January 1 to complete the buildings and landscape the grounds as required by the contract. Final inspection by the F. H. A. inspector was not made until January 17, 1950. As stated by the Tax Court in the Weil decision at page 815: "The statute is concerned with the realization of 'net income from the property.' It aims at a situation where before a substantial part of that net income has been realized, the individual stockholders take action designed to result in capital gain."

The petitioners further contend that the gains recognized on the cash distribution and the sale of stock are not within § 117(m) because at least 30% of those gains was attributable to apprecia-

[3] See discussion in Weil v. Commissioner, 28 T.C. 809.

tion on the value of the land "apart from building construction." [4] This is far too narrow an interpretation of the statute to be accepted. As to the cash distribution the Tax Court correctly held that all of it was directly attributable to the constructed property, since it was paid out of the funds advanced to Mott on the F. H. A. mortgage. The petitioners say that the Tax Court found as a fact that the "value of the land alone, at $1 per square foot, totaled $120,945." The entire statement from which the quotation is taken appears in the margin.[5] We think the petitioners have misinterpreted the court's statement. It made no finding that the land was worth $1 per square foot apart from the constructed building. Nor did Mott itself so treat the land value; its tax return for 1950 put down the land at cost, $59,000 and ascribed the increase in value of its property to "building fixtures and equipment."

The final contention asserts that even if the cash distribution is deemed to fall within § 117(m) the gain on the stock sale is not taxable under that section. The petitioners concede that a literal reading of subdivision (2)(A) would support the Tax Court's result but urge that the distribution and the stock sale should be tested separately. We agree with the Tax Court's view that the cash distribution brought Mott within the statutory definition. The statute contains no provision relieving a corporation from its "collapsible" status once an event has occurred which brings it within that definition. Although at first glance so literal an application might seem unfair, it is perfectly consistent with the purpose of the statute to tax as normal income all gains received before the realization of a substantial portion of the net income to be derived from the property. And if, subsequent to a condemned distribution, but prior to a stock sale, the corporation realizes a substantial part of the net income, a court should have no difficulty in holding § 117(m) inapplicable to such transaction.

We see no error in decision. It is affirmed.

Note

Closely related to the collapsible corporation provisions is sec. 312(b) which has the effect of increasing earnings and profits by the amount of unrealized appreciation in the case of distribution of certain inventory assets. These are defined as including

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[4] The 30% limitation is imposed by subdivision (3)(B) of § 117(m).

[5] "Early in January 1950, in answer to Herman's inquiry his accountant reported that if a recognized appraisal showed that improvements made were worth more than cost, Mott could distribute cash to its shareholders. Herman requested that a real estate firm make an immediate appraisal which on January 10, 1950 valued the land and buildings at $1,249,431. The value of the land alone, at $1 per square foot, totaled $120,945."

not only stock in trade and property held for sale to customers, but also "unrealized receivables or fees."

How far does this provision overlap the rules as to collapsible corporations?

E. STOCK DIVIDENDS

Sec. 305 of the 1954 Code

The taxability of stock dividends has been subject to a good deal of fluctuation in the development of the law. The present rule is clear and apparently simple. It will be helpful in understanding it, though, and in evaluating the possibilities of future change, to follow through the various stages which have preceded the present state of the law. These may be summarized as follows:

(1) The original income tax law contained no provision relating to the taxability of stock dividends. It simply imposed a tax on "income," from whatever source derived. In *Towne v. Eisner,* 245 U.S. 418 (1918), it was held that this should not be construed to impose a tax on the value of a stock dividend, paid in common shares on common shares.

(2) While this case was going through the courts, the statute was changed. In sec. 2(a) of the Revenue Act of 1916, it was provided that dividends should be taxable, whether paid "in cash or in stock of the corporation, . . . which stock dividend shall be considered income, to the extent of its cash value."

In *Eisner v. Macomber,* 252 U.S. 189 (1920), arising under this statute, a dividend of common stock on common stock was involved. The majority of the Court held that this was not taxable as income. The statute undertaking to tax such dividends was held unconstitutional. Such a dividend, the Court said, was not income within the meaning of the Sixteenth Amendment and therefore the attempt to tax it (without apportionment) exceeded the powers granted by that amendment.[1]

(3) Congress thereupon provided in sec. 201(d) of the Revenue Act of 1921 that "A stock dividend shall not be subject to tax . . ." (Note that this did not say that stock dividends were not income, but rather that they were not "subject to tax.") This seemed to make the law rather clear, and for the next fif-

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1 For discussions of this basic question, see Powell, "Stock Dividends, Direct Taxes and the Sixteenth Amendment," 20 Col.L.Rev. 536 (1920), 5 Selected Essays on Constitutional Law 750 (1938); Powell, "The Judicial Debate on the Taxability of Stock Dividends as Income," 5 Bull.Nat.Tax Ass'n 247 (1920); Seligman, "Are Stock Dividends Income?" 9 Am.Econ.Rev. 517 (1919). See also Whittaker, "The Stock Dividend Question," 19 Am.Econ.Rev. 20 (1929); Siegel, "Stock Dividends," 11 Harv.Bus.Rev. 76 (1932).

teen years stock dividends were not subject to tax, and it was generally believed that no stock dividend could be taxed.

(4) The next stage in the development was the decision in *Koshland v. Helvering*, 298 U.S. 441 (1936). In that case, the taxpayer had bought preferred stock. Under the articles of the company, dividends could be paid on this stock in common stock of the company. Both preferred and common were outstanding. In 1925 to 1928, the taxpayer received dividends in common shares on his preferred shares. In 1930, the *preferred* stock, *on* which the dividends had been paid, was redeemed. In determining the profit realized on this redemption, it was necessary to determine the adjusted basis of the preferred stock. The Commissioner held that this basis should be determined by allocating the original basis for the preferred over the preferred and the common received, in proportion to the fair market value of the shares. This had the effect of reducing the basis on the preferred, and thus in increasing the profit on the redemption of the preferred.

The Supreme Court held that the basis should not be reduced. Its reason for this conclusion was that this particular stock dividend was in fact income to the shareholder, even though Congress in the statutory provision quoted in paragraph (3) above chose not to tax it. The reason that this dividend was regarded as income was given in the following passage (pp. 445–446):

"We are dealing solely with an income tax act. Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old,—the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old,—does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest, different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. Whether Congress has taxed it as of the time of its receipt, is immaterial for present purposes. . . ."

Just why the receipt of a "different" interest, or a change in the "proportionate interest," should make the distribution taxable, and in the amount of its full market value, was not made clear.

Shortly after the *Koshland* case was decided, *Helvering v. Gowran,* 302 U.S. 238 (1937), came before the Court. In this case, a corporation with both preferred and common outstanding, paid a dividend on the common in preferred. Later it redeemed the preferred. The question again arose as to the basis, this time with respect to the dividend stock. The Court held that the pre-

ferred stock dividend had been income, though it was not in fact taxed under the statute at that time. The Court further held that the shareholder's basis on the new stock was zero, since it had not been taxed on receipt, with the result that the entire amount received on the redemption was income.[2]

(5) Immediately after the *Koshland* case was decided, Congress amended what became sec. 115(f) of the 1939 Code so as to provide that a stock dividend should not be income "to the extent that it does not constitute income . . . within the meaning of the Sixteenth Amendment to the Constitution." The statute remained in this form until the adoption of the Internal Revenue Code of 1954.

Under this statute several cases were decided. In *Helvering v. Griffiths*, 318 U.S. 371 (1943), the Government sought to tax the recipient of an ordinary stock dividend of common stock on common stock when the corporation had only common stock outstanding. The Court, speaking through Mr. Justice Jackson, held that the statute should not be construed to reach such a dividend. If such a dividend was taxable, then all stock dividends would be taxable. The Court concluded that if Congress had contemplated such a result, it would not have written the statute the way it did. The opinion left little room to doubt that a statute explicitly taxing all stock dividends would be upheld. Justices Douglas, Black and Murphy dissented, taking the position that the stock dividend was taxable under the statute.

In *Helvering v. Sprouse*, 318 U.S. 604 (1943), a corporation with only common stock outstanding, and a single stockholder, issued a dividend in non-voting preferred stock. The Court held that this question was controlled by the decision in the *Griffiths* case, and that the dividend was not taxable. The opinion was written by Mr. Justice Roberts. Justices Reed, Frankfurter and Jackson dissented.[3]

(6) The cycle came around again to complete nontaxability when sec. 305 of the Internal Revenue Code of 1954 was enacted. Under this, distributions in the stock of the distributing corporation—any stock, under any situation with respect to the

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2 The situation as it existed under the rule of the Koshland case is discussed in "Taxation of Stock Dividends under the 'Different Interest' Test," 51 Harv.L.Rev. 702 (1938); James, "The Present Status of Stock Dividends under the Sixteenth Amendment," 6 U. of Chi.L.Rev. 215 (1939).

3 For consideration of the stock dividend situation during this period, see Kanter, "The Present Tax Status of Stock Dividends," 31 Taxes 418 (1953); "Taxability of Stock Dividends," 38 Va.L.Rev. 79 (1952); Altman, "The Effect of Recent Stock Dividend Decisions," 21 Taxes 251 (1943); Ashbaugh, "Legislation and Litigation in re Stock Dividends," 76 J. of Accountancy 11 (1943); Zang and Thompson, "Why Stock Dividends Are Declared," 27 Taxes 883 (1949).

stock—are not included in gross income. The same rule applies to distributions of rights to acquire the stock of the distributing corporation.

There are two exceptions to this rule: (a) where the distribution is in discharge of preference dividends for the taxable year or for the preceding taxable year—an unlikely possibility, for when preference dividends get into the situation that they have to be paid off in stock they are likely to be much more than two years in arrears; and (b) where the distribution is, at the election of *any* shareholder, payable either in stock or in cash or other property.

See, generally, Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 168–170; Lee, "The Stock Dividend," 37 Taxes 959 (1959).

The problems which may arise under this are yet to be seen. One of them, involving sec. 306 of the 1954 Code, is referred to below.

Notes

Some of the situations arising under the previous law should be understood as background for the consideration of the statute in its present form.

(A) A number of questions arose as to when there was such a change in the proportional interests of the shareholders that there was a taxable distribution. In *Tourtelot v. Commissioner,* 189 F.2d 167 (C.A.7th, 1951), and *Wiegand v. Commissioner,* 194 F.2d 479 (C.A.3d, 1952), both arising out of the same distribution, the situation was this. A corporation had class A stock and class B stock outstanding. The class A stock had a preference as to dividends and on distribution. Then the class B stock was entitled to a stated amount of dividends, and on distribution, after which the two classes shared equally. A dividend was declared of ½ share of A stock on the A stock, and ½ share of B stock on the B stock. Both courts held that this was not a taxable distribution. It seems obvious, though, that there was some change in the proportionate interests of the shareholders. The class A shareholders had not only a larger preference, but also a larger dollar claim after the distribution than they had before it was made.[4]

(B) Another problem was illustrated by *Schmitt v. Commissioner,* 208 F.2d 819 (C.A.3d, 1953). In that case a widow inherited from her husband 1486 shares of the stock of a company. All of the rest of the stock was owned by two principal employees —A owned 168 shares and B owned 199 shares. After various other plans for working out the problem had been tried, and failed, an arrangement was entered into in 1937 under which the corporation agreed to buy the 1486 shares from the widow. Payment was made to her over the period from 1937 through 1947. As the shares were reacquired they were held in the corpora-

[4] There is a comment on these cases in 65 Harv.L.Rev. 1247 (1952).

tion's treasury. During this period the corporation paid no dividends on its stock. After all of the shares were reacquired, the corporation, by proper corporate action, distributed them to the two remaining shareholders, in proportion to their holdings. The court held that this distribution was not a taxable dividend.[5]

(C) *Chamberlin v. Commissioner,* 207 F.2d 462 (C.A.6th, 1953), involved what is known as a "preferred stock bail-out." [6] A corporation which had only common stock outstanding, declared a dividend payable in preferred stock. At the time the distribution was made, there was an arrangement with an insurance company to buy all of the preferred stock, and this was done. The preferred stock had a sinking fund provision under which it was redeemed by the company, ratably over a period of years. The Tax Court held the distribution taxable, since the whole plan viewed together, involved a change in the proportional interests of the shareholders. This was reversed by the Court of Appeals, which held that this was a non-taxable stock dividend.[7]

See Black, "Common Stock and the Bail-Out Section," 38 Taxes 395 (1960); Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 246–254; Harris, "The Status of Preferred Stock Bail-Outs," 34 Taxes 403 (1956); Alexander and Landis, "Bail-Outs and the Internal Revenue Code of 1954," 65 Yale L.J. 909 (1956).

Since the 1954 Code was enacted, a plan has been devised under which a company would have two classes of common stock, one paying a dividend in cash, and the other paying a dividend in stock only. At first, the Treasury ruled that the stock received by the shareholders receiving stock would be a stock dividend, and not taxable. However, the Treasury in 1956 proposed a revision of sec. 1.305–2 of the Income Tax Regulations which would make such a distribution taxable. Certain amendments were made to sec. 1.305–2 on June 30, 1960, but this particular matter was reserved for further consideration.

Dispositions of Dividend Stock

Sec. 306 of the 1954 Code

The situation illustrated by the *Chamberlin* case gives the background for the provision which was newly added as sec. 306 of the 1954 Code.[8] This is a complicated and highly inte-

5 See Moore, "Taxation of Treasury Stock Dividends," 97 J. of Accountancy 179 (1954).

6 For consideration of this question, see Darrell, "Recent Developments in Non-Taxable Reorganizations and Stock Dividends," 61 Harv.L.Rev. 958 (1948); DeWind, "Preferred Stock 'Bail Outs' and the Income Tax," 62 Harv. L.Rev. 1126 (1949); Dauber, "Preferred Stock Dividends: Permanency of Interest and the Federal Income Tax Law," 8 Rutgers L.Rev. 472 (1954).

7 For discussion of the problems suggested by the Schmitt and the Chamberlin cases, see "Use of Stock Redemptions to Purchase a Corporation out of Future Earnings," 67 Harv.L.Rev. 1387 (1954); "Dividend Equivalence in the Purchase of a Corporation with Its Own Assets," 40 Va.L.Rev. 43 (1954).

8 The genesis of this provision, in a rather more complicated form, may be found in a comprehensive article dealing with stock dividend problems: Cohen, Surrey, Tarleau and Warren, "A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders," 52 Col. L.Rev. 1 (1952).

grated provision. Its basic purpose is not to tax stock dividends —which it does not do—but to provide for a tax consequence on the sale or redemption of the dividend stock under certain circumstances. It establishes a new category of "section 306 stock," which includes all stock issued as a stock dividend, and not taxable under sec. 305, except common stock issued on common stock. Thus it clearly reaches some distributions, such as preferred on common with only common outstanding, which were not taxable under the previous law. It also reaches certain stock, other than common stock, received in connection with a corporate reorganization or division. See, generally, Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 247–254, 349–352, 390–391.

Under sec. 306(a), the disposition or redemption of section 306 stock will result in ordinary income, subject to the exceptions stated in sec. 302(b). See also the important provisions in sec. 318, relating to "attribution of ownership." [9]

Note and Problem

(A) A common shareholder receives a distribution in preferred stock of the same corporation. He gives it to a charity. The Treasury ruled that (1) he gets a deduction for a charitable contribution, and (2) there is no income to the donor either on the transfer or on subsequent sale of the stock by the charity. Rev.Rul. 57–328, 1957–2 Cum.Bull. 229.

(B) Is the new rule, under secs. 305 and 306, a desirable one? What problems will arise? What loopholes, if any, have been left open? What hardships may be caused under the new law?

(C) Contrary to the present solution of the problem, it has been argued that Congress should make all stock dividends taxable. See Lowndes, "The Taxation of Stock Dividends and Stock Rights," 96 U. of Pa.L.Rev. 147 (1947). If this were done, should a line be drawn between a stock dividend and a "split up"? Should the capitalization of earnings be a controlling test? See *Bass v. Commissioner,* 129 F.2d 300 (C.C.A.1st, 1942).

Basis

Sec. 307 of the 1954 Code

Under sec. 307 of the 1954 Code, where there has been a stock distribution to which sec. 305 applies, the basis of the old and the new stock after the distribution shall be determined by allocating the old basis between the old and the new. This allocation

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[9] See Reilly, "An Approach to the Simplification and Standardization of the Concepts 'The Family,' 'Related Parties,' 'Control,' and 'Attribution of Ownership,'" 15 Tax L.Rev. 253 (1960); Plowden-Wardlaw, "Constructive Ownership under the 1954 Internal Revenue Code," 26 Fordham L.Rev. 441 (1957); Wolfman, "Some of the Attribution of Ownership Problems Involved in the Redemption of Stock under the 1954 Code," 33 Taxes 382 (1955).

is to be made in accordance with regulations to be prescribed. Ordinarily, it is in proportion to the fair market values of the old and the new stock immediately after the distribution. See sec. 1.307–1 of the Income Tax Regulations.

The previous basis provision was sec. 113(a)(19) of the 1939 Code.[9] This remains fully in effect as to all distributions which occurred prior to June 22, 1954. See secs. 391, 395 and 1052 of the 1954 Code.

Effect on Earnings and Profits

Sec. 312(d) of the 1954 Code

The effect of a stock dividend on the earnings and profits of the distributing corporation is now covered by sec. 312(d) of the 1954 Code. The rule can now be rather simple since no stock dividends are currently taxable.

The previous rule, which necessarily differentiated between taxable and non-taxable stock dividends, was more complicated. It was found in sec. 115(h) of the 1939 Code.[10] It remains in effect as to all distributions made prior to June 22, 1954 (sec. 312 (d)(2))—since sec. 305(a) is appplicable only to distributions made on or after that date. Sec. 391.

Stock Rights

The rules as to stock dividends are also applicable to distributions of rights to acquire the stock of the distributing corporation. See sec. 305(a). The rules as to section 306 stock are applicable to that portion of the stock acquired under rights which is represented by the value of the rights, but not to the portion for which payment is made at the time of the exercise of the rights. Sec. 306(d).

Basis. The rule prescribed in sec. 307 for determining basis of stock distributions by allocating the old basis over the old and the new stock is also applicable to distributions of rights to subscribe to stock. Sec. 307(a). However, sec. 307(b) provides that unless the shareholder elects to the contrary, a right whose value is less than 15 per cent of the value of the old stock shall take a basis of zero (with the old stock retaining its full basis, without allocation). This rule will often be a considerable con-

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9 For discussions of this provision, see Eichholz, "The Revenue Act of 1939 and the Basis of Stock Dividends and Rights," 40 Col.L.Rev. 404 (1940); Alvord and Biegel, "Basis Provisions for Stock Dividends under the 1939 Revenue Act," 49 Yale L.J. 841 (1940).

10 See York, "Stock Dividends from the Viewpoint of the Declaring Corporation," 16 Accounting Rev. 15 (1941). See also Accounting Research Bulletin No. 11—"Accounting for Stock Dividends and Split Ups," 95 J. of Accountancy 44 (1953).

venience, but most taxpayers will probably want to consider whether it is desirable for them to make the election provided by sec. 307(b). Where the rights are exercised, it ordinarily will not make much difference. However, where the rights are sold, the immediate tax on the sale will ordinarily be reduced (where the old stock is retained) if a portion of the old basis is allocated to the rights. See Whiteside, "Income Tax Consequences of Distributions of Stock Rights to Shareholders," 66 Yale L.J. 1016 (1957).

For a treatment of the older law on the issue, sale, exercise and expiration of warrants or rights, see G.C.M. 25,063, 1947-1 Cum.Bull. 45.

F. CORPORATE REORGANIZATIONS AND DIVISIONS

Secs. 351-382 of the 1954 Code

Many of the early questions in the tax field had to do with the "realization" of income. It was felt that income could not be taxed until it was "realized," and it became necessary to tell under various facts whether income had been realized. One of the important cases where this question was considered was *Eisner v. Macomber,* 252 U.S. 189 (1920), the stock dividend case referred to above, in which it was held that a dividend paid in common stock with only common stock outstanding did not constitute the realization of income and could not constitutionally be taxed by Congress. As Mr. Justice Holmes said in *Towne v. Eisner,* 245 U.S. 418, 426 (1918): "In short, the corporation is no poorer and the stockholder is no richer than they were before [the stock dividend]."

The problem of realization was also presented to the Court in a series of early cases involving corporate reorganizations. Thus, in the absence of a statute to the contrary, is there income on the following facts: The duPont Company of New Jersey had a capitalization of $60,000,000, of which about $30,000,000 was represented by common stock. It had a surplus sufficient to cover the distribution which was made. Pursuant to authority from the stockholders, a new duPont Company was organized in Delaware with a capitalization of $240,000,000. All of the assets of the New Jersey company were transferred to the Delaware Company at a valuation of $120,000,000, which was paid, half in the six per cent debenture stock of the Delaware company, and half in common stock. The common stock was distributed to the shareholders of the New Jersey company, so that each received two shares of the Delaware stock for each of his New Jersey shares. The New Jersey corporation remained in existence holding the debenture stock as its only asset.

These were the facts of *United States v. Phellis,* 257 U.S. 156 (1921). Other cases presenting a similar question include *Rockefeller v. United States,* 257 U.S. 176 (1921); *Cullinan v. Walker,* 262 U.S. 134 (1923); *Weiss v. Stearn,* 265 U.S. 242 (1924); and *Marr v. United States,* 268 U.S. 536 (1925). These cases are carefully discussed in Magill, Taxable Income 65–80 (2d ed. 1945). See also Finkelstein, "The Corporate Entity and the Income Tax," 44 Yale L.J. 436 (1935). They remain important for the light they cast on the realization problem. They are the background of the corporate reorganization provisions of the statute which now envelop this field in a maze of legislative detail.

The principal provisions of the statute relating to reorganizations are now found in secs. 354, 361, and 368 of the 1954 Code. The corresponding provisions of the 1939 Code was secs. 112(b) (3) and (4), and 112(g). Other provisions of the statute in this area are also of great importance and will be referred to below. See especially sec. 351 of the 1954 Code (formerly sec. 112(b) (5) of the 1939 Code) to which reference has already been made in the capital gains chapter, above.

These provisions of the statute should all be examined carefully. Their general effect is to make an "exchange" of stock or securities in connection with a "reorganization", a transaction on which neither gain nor loss is recognized. In sec. 355, this is extended in certain cases to "distributions" of stock and securities, even though no "exchange" is involved.

The history of the federal tax treatment of corporate reorganizations may be divided into a number of periods, and an understanding of this background will help in the comprehension of the present statutory provisions. There have been:

(1) The period of omission (1913–1919). These are the years which gave rise to the cases cited a few paragraphs above.

(2) The period of expansion (1919–1924). Section 202(b)(2) of the Revenue Act of 1918 contained rather limited reorganization provisions; and these were expanded in sec. 202(c)(2) of the 1921 Act. This change was made, according to the committee reports, to "permit business to go forward with the readjustments required by existing conditions." House Report No. 350, 67th Congress, 1st Session (1921) 10.

(3) The period of exploitation (1925–1932). This was the time when it was sought to use the reorganization provisions as a loophole which would permit the avoidance of the tax in any number of situations which had only a formal relation to a corporate reorganization.

(4) The period of contraction (after 1933, and continuing with some modification near the end until 1954). At the beginning of this period, Congress sought to close up the holes in the statute, and the Court did its part towards the same end.

(5) The period under the 1954 Code. Whether there will be any substantial change remains to be seen. For the most part, the provisions of the 1954 Code with respect to reorganizations are simply a rewriting and rearrangement of the previous law, without any very substantial changes in the basic effect of the provisions. There are a considerable number of changes in detail, however, and the general approach in recent years has been somewhat more favorable to taxpayers in this area than it was in the period immediately following 1933. What developments Congress may yet make in the statute, and what the courts may do with the statute as it now stands, remain to be seen.[1]

For general discussions, see Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 357–401; Hellerstein, "Mergers, Taxes and Realism," 71 Harv.L.Rev. 254 (1957); Dane, "The Case for Non-recognition of Gains in Reorganization Exchanges," 36 Taxes 244 (1958); Darrell, "The Use of Reorganization Techniques in Corporate Acquisitions," 70 Harv.L.Rev. 1183 (1957). See also Leake, "Problems in Corporate Acquisitions," 13 Tax L.Rev. 67 (1957).

In the construction and application of the provisions which have now been carried forward into the 1954 Code, the courts have developed three important doctrines which have become in effect the "common law" of corporate reorganizations in the tax field. These doctrines remain of great importance for the indication they give of the "approach" which the courts will take to problems in this area. These doctrines are:

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1 The problems under the 1954 Code are considered in Merritt, "Tax-Free Acquisition of Corporate Business," Proc.N.Y.U. 13th Ann. Inst. on Federal Taxation 693 (1954); Holzman, "The New Reorganization Doctrine," 33 Taxes 743 (1955); Swados, "Tax-Free Sale of a Business: Reorganizations, Spin-Offs, and Other Feats of Magic Under the 1954 Code," Buffalo L.Rev. 117 (1956); Bakst "Does Dissolution Followed By Reincorporation Constitute A Reorganization?" 33 Taxes 815 (1955); Stinson, "Some Subchapter C Trouble Spots—After Two Years," 34 Taxes 890 (1956); Manning, "'In Pursuance of the Plan of Reorganization': The Scope of the Reorganization Provisions of the Internal Revenue Code," 72 Harv.L.Rev. 881 (1959).

Greene, "Proposed Definitional Changes in Reorganizations," 14 Tax L.Rev. 155 (1959), discusses the existing reorganization sections and the provisions of a current statutory proposal which would substantially amend them.

For an earlier consideration of the problems in this area, with emphasis on the business point of view, see Butters, Lintner and Cary, Effects of Taxation on Corporate Mergers (1951).

(1) The "business purpose" doctrine—illustrated by the *Gregory* and *Bazley* cases which follow.

(2) The "step transaction" doctrine, under which a corporate adjustment is looked at as a whole. Even though it may consist of several steps, each of which considered alone would be tax-free, the entire transaction will not be tax-free if, as a whole, it does not meet the requirements of the statute. This is illustrated by the *Elkhorn Coal* and *Bausch & Lomb* cases, on pages 726, 727, below.

Consider the following sentence from the Supreme Court's opinion in *Minnesota Tea Co. v. Helvering,* 302 U.S. 600, 613: "A given result at the end of a straight path is not made a different result by following a devious path."

(3) The "continuity of interest" doctrine. This was established in *Pinellas Ice & Cold Storage Co. v. Commissioner,* 287 U.S. 462 (1933), and *Le Tulle v. Scofield,* 308 U.S. 415 (1940). What is believed to be a misapplication of it is presented in the *Neville Coke & Chemical* case, at p. 730, below.

In considering the *Gregory* case below, it should be pointed out that the statutory provision under which it arose is no longer in effect in the terms involved in that case, although sec. 355 in a much more elaborate and controlled manner covers somewhat the same area. The Revenue Act of 1928 included as sec. 112(g) a provision (quoted in the *Gregory* opinion) under which a *distribution* might be made in connection with a reorganization, without the surrender of any securities, and such a distribution might be received without gain to the distributee. This provision was repealed by the Revenue Act of 1932, and thereafter the reorganization provisions were applicable for many years only to "exchanges." As is pointed out below, new provisions relating to distributions were added to the 1939 Code in 1951, and these are carried forward into sec. 355 of the 1954 Code.[2] But these would clearly not cover the distribution in the *Gregory* case because of the requirement of sec. 355(b) that the controlled corporation must have been actively conducting a trade or business for at least the five years preceding the distribution.

Although the statutory provisions are now quite different, and the precise question involved in the *Gregory* case would be quite clear under the present law, the general doctrine announced in the *Gregory* case remains in full vitality, as the *Bazley* case shows, and is also applied in other fields of the tax law.

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[2] See also the provisions of sec. 1081 of the 1954 Code, relating to distributions made in obedience to an order of the Securities and Exchange Commission under the Public Utility Holding Company Act.

GREGORY v. HELVERING

Supreme Court of the United States, 1935. 293 U.S. 465.

MR. JUSTICE SUTHERLAND delivered the opinion of the Court.

Petitioner in 1928 was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the Monitor Securities Corporation. For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a "reorganization" under section 112(g) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 818, set forth later in this opinion. To that end, she caused the Averill Corporation to be organized under the laws of Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation as capital net gain the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction.

The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance and must be disregarded, held that petitioner was liable for a tax as though the United corporation had paid her a dividend consisting of the amount realized from the sale of the Monitor shares. In a proceeding before the Board of Tax Appeals, that body rejected the commissioner's view and upheld that of petitioner. 27 B.T.A. 223. Upon a review of the latter decision, the circuit court of appeals sustained the commissioner and reversed the board, holding that there had been no "reorganization" within the meaning of the statute. 69 F.2d 809. Petitioner applied to this court for a writ of certiorari, which the government, considering the question one of importance, did not oppose. We granted the writ. 293 U.S. 538.

Sec. 112 of the Revenue Act of 1928 deals with the subject of gain or loss resulting from the sale or exchange of property. Such gain or loss is to be recognized in computing the tax, ex-

cept as provided in that section. The provisions of the section, so far as they are pertinent to the question here presented, follow:

"Sec. 112(g). *Distribution of stock on reorganization.*—If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized. . . .

"(i) *Definition of reorganization.*—As used in this section . . .

"(1) The term 'reorganization' means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, . . ."

It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *United States v. Isham,* 17 Wall. 496, 506; *Superior Oil Co. v. Mississippi,* 280 U.S. 390, 395–6; *Jones v. Helvering,* 71 F.2d 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" [sec. 112(g)] of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the peti-

tioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Judgment affirmed.[1]

BAZLEY v. COMMISSIONER

Supreme Court of the United States, 1947. 331 U.S. 737.

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

The proper construction of provisions of the Internal Revenue Code relating to corporate reorganizations is involved in both these cases. Their importance to the Treasury as well as to corporate enterprise led us to grant certiorari, 329 U.S. 695, 329 U.S. 701. While there are differences in detail to which we shall refer, the two cases may be disposed of in one opinion.

In the *Bazley* case, No. 287, the Commissioner of Internal Revenue assessed an income tax deficiency against the taxpayer for the year 1939. Its validity depends on the legal significance of the recapitalization in that year of a family corporation in which the taxpayer and his wife owned all but one of the Company's one thousand shares. These had a par value of $100. Under the plan of reorganization the taxpayer, his wife, and the holder of the additional share were to turn in their old shares and receive in exchange for each old share five new shares of no par value, but of a stated value of $60, and new debenture bonds, having a total face value of $400,000, payable in ten years but callable at any time. Accordingly, the taxpayer received 3,990

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[1] The following sentence is from the opinion of Judge Learned Hand in the court below, Helvering v. Gregory, 69 F.2d 809, 811 (C.C.A.2d, 1934): "It is quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create."

shares of the new stock for the 798 shares of his old holding and debentures in the amount of $319,200. At the time of these transactions the earned surplus of the corporation was $855,783.82.

The Commissioner charged to the taxpayer as income the full value of the debentures. The Tax Court affirmed the Commissioner's determination, against the taxpayer's contention that as a "recapitalization" the transaction was a tax-free "reorganization" and that the debentures were "securities in a corporation a party to a reorganization," "exchanged solely for stock or securities in such corporation" "in pursuance of a plan of reorganization," and as such no gain is recognized for income tax purposes. Internal Revenue Code, §§ 112(g)(1)(E) and 112(b)(3). The Tax Court found that the recapitalization had "no legitimate corporate business purpose" and was therefore not a "reorganization" within the statute. The distribution of debentures, it concluded, was a disguised dividend, taxable as earned income under §§ 22(a) and 115(a) and (g). 4 T.C. 897. The Circuit Court of Appeals for the Third Circuit, sitting en banc, affirmed, two judges dissenting. 155 F.2d 237.

Unless a transaction is a reorganization contemplated by § 112(g), any exchange of "stock or securities" in connection with such transaction, cannot be "in pursuance of the plan of reorganization" under § 112(b)(3). While § 112(g) informs us that "reorganization" means, among other things, "a recapitalization," it does not inform us what "recapitalization" means. "Recapitalization" in connection with the income tax has been part of the revenue laws since 1921. 42 Stat. 227, 230, 202(c)(2). Congress has never defined it and the Treasury Regulations shed only limited light. Treas.Reg. 103, § 19.112(g). One thing is certain. Congress did not incorporate some technical concept, whether that of accountants or of other specialists, into § 112(g), assuming that there is agreement among specialists as to the meaning of recapitalization. And so, recapitalization as used in § 112(g) must draw its meaning from its function in that section. It is one of the forms of reorganization which obtains the privileges afforded by § 112(g). Therefore, "recapitalization" must be construed with reference to the presuppositions and purpose of § 112(g). It was not the purpose of the reorganization provision to exempt from payment of a tax what as a practical matter is realized gain. Normally, a distribution by a corporation, whatever form it takes, is a definite and rather unambiguous event. It furnishes the proper occasion for the determination and taxation of gain. But there are circumstances where a formal distribution, directly or through exchange of securities, represents merely a new form of the previous participation in an enterprise, involving no change of substance in the rights and relations of the interested parties

one to another or to the corporate assets. As to these, Congress has said that they are not to be deemed significant occasions for determining taxable gain.

These considerations underlie § 112(g) and they should dominate the scope to be given to the various sections, all of which converge toward a common purpose. Application of the language of such a revenue provision is not an exercise in framing abstract definitions. In a series of cases this Court has withheld the benefits of the reorganization provision in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind with which § 112, in its purpose and particulars, concerns itself. See *Pinellas Ice and Cold Storage Co. v. Commissioner,* 287 U.S. 462; *Gregory v. Helvering,* 293 U.S. 465; *Le Tulle v. Scofield,* 308 U.S. 415.

Congress has not attempted a definition of what is recapitalization and we shall follow its example. The search for relevant meaning is often satisfied not by a futile attempt at abstract definition but by pricking a line through concrete applications. Meaning frequently is built up by assured recognition of what does not come within a concept the content of which is in controversy. Since a recapitalization within the scope of § 112 is an aspect of reorganization, nothing can be a recapitalization for this purpose unless it partakes of those characteristics of a reorganization which underlie the purpose of Congress in postponing the tax liability.

No doubt there was a recapitalization of the Bazley corporation in the sense that the symbols that represented its capital were changed, so that the fiscal basis of its operations would appear very differently on its books. But the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them. Corporate accounting may represent that correspondence between change in the form of capital structure and essential identity in fact which is of the essence of a transaction relieved from taxation as a reorganization. What is controlling is that a new arrangement intrinsically partake of the elements of reorganization which underlie the Congressional exemption and not merely give the appearance of it to accomplish a distribution of earnings. In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization. The governing legal rule can hardly

be stated more narrowly. To attempt to do so would only challenge astuteness in evading it. And so it is hard to escape the conclusion that whether in a particular case a paper recapitalization is no more than an admissible attempt to avoid the consequences of an outright distribution of earnings turns on details of corporate affairs, judgment on which must be left to the Tax Court. See *Dobson v. Commissioner,* 320 U.S. 489.

What have we here? No doubt, if the Bazley corporation had issued the debentures to Bazley and his wife without any recapitalization, it would have made a taxable distribution. Instead, these debentures were issued as part of a family arrangement, the only additional ingredient being an unrelated modification of the capital account. The debentures were found to be worth at least their principal amount, and they were virtually cash because they were callable at the will of the corporation which in this case was the will of the taxpayer. One does not have to pursue the motives behind actions, even in the more ascertainable forms of purpose, to find, as did the Tax Court, that the whole arrangement took this form instead of an outright distribution of cash or debentures, because the latter would undoubtedly have been taxable income whereas what was done could, with a show of reason, claim the shelter of the immunity of a recapitalization-reorganization.

The Commissioner, the Tax Court and the Circuit Court of appeals agree that nothing was accomplished that would not have been accomplished by an outright debenture dividend. And since we find no misconception of law on the part of the Tax Court and the Circuit Court of Appeals, whatever may have been their choice of phrasing, their application of the law to the facts of this case must stand. A "reorganization" which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under § 112. This disposes of the case as a matter of law, since the facts as found by the Tax Court bring them within it. And even if this transaction were deemed a reorganization, the facts would equally sustain the imposition of the tax on the debentures under § 112(c)(1) and (2). *Commissioner v. Estate of Bedford,* 325 U.S. 283. . . .

Judgments affirmed.

MR. JUSTICE DOUGLAS and MR. JUSTICE BURTON dissent in both cases for the reasons stated in the joint dissent of Judges Maris and Goodrich in the court below. *Bazley v. Commissioner,* 155 F.2d 237, 244.

Notes

(A) For discussions of the "business purpose" doctrine see Michaelson, " 'Business Purpose' and Tax-Free Reorganization," 61 Yale L.J. 14 (1952); Freedman, "The Bazley Case—A Retreat from the Recapitalization to Uncertainty," 27 Tex.L.Rev. 66 (1948); Spear, " 'Corporate Business Purpose' in Reorganization," 3 Tax L.Rev. 225 (1947); Lourie, "The Business Purpose Doctrine," 25 Taxes 800 (1947). See also Holzman, "Ten Years of the Gregory Case," 79 J. of Accountancy 215 (1945); Flack, "Where Tax Saving is Behind the Business Purpose," 23 Taxes 910 (1945).

(B) The actual problem of the *Bazley* case is now apparently covered by the provision in sec. 354(a)(2) relating to the receipt of securities in a principal amount greater than that given up, or to the receipt of securities without the surrender of securities. In such a case the fair market value of the excess value of the securities received becomes taxable under sec. 356.

This would apparently apply to a recapitalization in which new bonds were exchanged for old preferred stock. Under the prior law there were cases holding that such an exchange was a reorganization, and did not result in any current tax. See *Davis v. Penfield,* 205 F.2d 798 (C.A.5th, 1953); *Daisy Seide,* 18 T.C. 502 (1952).

(C) *Recapitalization.* One of the types of transactions which qualifies as a "reorganization" under sec. 368(a)(1)(E) of the 1954 Code is "recapitalization." The meaning of this term is far from clear. In *Helvering v. Southwest Consolidated Corp.,* 315 U.S. 194, 202 (1942), the Court referred to a recapitalization as "that reshuffling of a capital structure, within the framework of an existing corporation." See page 734(C), below.[1]

For many years, the Treasury refused to recognize an exchange of bonds for bonds as being within the term, "recapitalization," and thus a "reorganization." It held that such an exchange was a "refinancing," and that any gain or loss on the exchange was recognized for tax purposes. I.T. 2035, III-1 Cum. Bull. 55 (1924); I.T. 2778, XIII-1 Cum.Bull. 79 (1934). But this view was not accepted in *Commissioner v. Neustadt's Trust,* 131 F.2d 528 (C.C.A.2d, 1942), where an exchange of bonds for bonds was held to be a recapitalization. The Treasury has now acquiesced in this conclusion, and revoked the earlier rulings. I.T. 4081, 1952-1 Cum.Bull. 65. See "The Exchange of Bonds as Non-Taxable Recapitalization," 53 Col.L.Rev. 127 (1953).

The provisions of sec. 354(a)(2) of the 1954 Code would appear to be applicable to such an exchange, so that it would now be tax free only to the extent that the principal amount of the securities received did not exceed the principal amount of those given up.

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[1] See Golomb, "Recapitalization: The Definition Problem," 7 Tax L.Rev. 343 (1952); Swartz, "Recapitalization," 24 Taxes 208 (1946). See also Chase, "Recapitalizations—Problems of Interest Deductions, Taxable Dividends and Taxable Exchanges," 1 Tax L.Rev. 465 (1946).

(D) *Transfers to a controlled corporation.* Although the questions with which we are now concerned arise primarily with respect to corporate *re*organizations, a reorganization often involves the organization of a new corporation. Sec. 351 of the 1954 Code is not confined to reorganization situations. It is also applicable to the simple transfer of property to a newly organized corporation, in exchange for its stock, as we have seen above. Under this provision, no gain or loss is recognized on such a transfer if the transferors of the property are in control of the corporation immediately after the transfer.

Until 1954, the predecessor of sec. 351 (which was sec. 112(b) (5) of the 1939 Code) required that the stock or securities of the transferee corporation must be issued to each transferor (where there was more than one) "substantially in proportion to his interest in the property prior to the exchange." Considerable question arose as to the meaning and application of this phrase. See *Bodell v. Commissioner,* 154 F.2d 407 (C.C.A.1st, 1946); Hoffman, "The Substantial Proportion Requirement of Section 112(b)(5)," 5 Tax L.Rev. 235 (1950).

This requirement has been removed under sec. 351 of the 1954 Code. Such transfers will be tax free if all of the transferors taken together are in control of the corporation after the transfer even though the stock and securities they receive are disproportionate to the value of the property each gives up. However, the Committee Reports make it clear that in such a case there may be a gift, or the payment of compensation for services. See also secs. 1.351–1 through 1.351–3 of the Income Tax Regulations.

For a thorough discussion of sec. 351, see Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 74–110. See also Bittker, "The Corporation and the Federal Income Tax: Transfers to a Controlled Corporation," 1959 Wash. U.L.Q. 1.

Step Transactions

Corporation M desired to acquire the operating assets of Corporation E, but not its investments, which were substantial. E thereupon organized Corporation X to which it transferred all of the investment assets. X issued all of its stock to E, which distributed it to its shareholders. E then transferred its remaining assets to M for stock of M; E was dissolved and the M stock was distributed to E's shareholders. It was contended that each step in this transaction was tax free, and that therefore the entire transaction must be tax free. The court held, however, that the transaction must be viewed as a whole, and that the transfer of E's operating properties to M was not tax free since it did not constitute the transfer of substantially all of E's properties. *Helvering v. Elkhorn Coal Co.,* 95 F.2d 732 (C.C.A.4th, 1938).

See also *Bassick v. Commissioner*, 85 F.2d 8 (C.C.A.2d, 1936), cert. den. 299 U.S. 592 (1936); Rev.Rul. 96, 1954–1 Cum.Bull. 111.[1]

At the time this transaction arose, sec. 112(g) of the Revenue Act of 1928 as it appeared in the *Gregory* case was in the statute. It was contended that this took care of the first step, the organization of X and the distribution of its stock to E's shareholders. It was then contended that the next step came within the definition of a reorganization (now found in sec. 368(a)(1)(C) of the 1954 Code), since M acquired substantially all of the (remaining) assets of E. As indicated, however, the court looked at the transaction as a whole and found that M did not in substance acquire "substantially all" of the assets of E, as required by the statute.

BAUSCH & LOMB OPTICAL CO. v. COMMISSIONER

United States Court of Appeals, Second Circuit, 1959. 267 F.2d 75.
Certiorari denied 361 U.S. 835 (1959).

MEDINA, CIRCUIT JUDGE. Petitioner Bausch & Lomb Optical Company, a New York corporation engaged in the manufacture and sale of ophthalmic products, on March 1, 1950 owned 9923¼ shares of the stock of its subsidiary Riggs Optical Company, or 79.9488% of the 12,412 outstanding shares of Riggs. In order to effectuate certain operating economies, Bausch & Lomb decided to amalgamate Riggs with itself. To this end on April 22, 1950 Bausch & Lomb exchanged 105,508 shares of its unissued voting stock for all of the Riggs assets. An additional 433 shares of Bausch & Lomb stock went to 12 Riggs' employees.

On May 2, 1950, according to a pre-arranged plan, Riggs dissolved itself, distributing its only asset, Bausch & Lomb stock, pro rata to its shareholders. Bausch & Lomb thus received back 84,347 of its own shares which became treasury stock, while 21,161 shares went to the Riggs minority shareholders.

The Commissioner determined that the substance of these transactions was that Bausch & Lomb received the Riggs assets partly in exchange for its Riggs stock and partly for its own stock, and that the gain which Bausch & Lomb realized upon the Riggs "liquidation" was subject to tax. In other words, that Bausch & Lomb parted with 21,161 shares of its own voting stock, plus 9923¼ shares of its Riggs stock, for the transfer to it of all of the Riggs assets. Bausch & Lomb contends, however, that a "reorganization" was effected under Section 112(g)(1)(C) of the 1939 Internal Revenue Code,[1] and that it is therefore entitled to

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[1] See Paul and Zimet, "Step Transactions," in Paul, Selected Studies in Federal Taxation 200 (1938); Thomson, "Step Reorganizations," 12 Tax Mag. 286 (1934).

[1] Section 112(g)(1)(C) provides:

"(1) The term 'reorganization' means * * *

"(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation,

tax-free treatment.[2] The Tax Court sustained the Commissioner's position and held that the acquisition of the Riggs assets and the dissolution of Riggs must be viewed together, and that the surrender by Bausch & Lomb of its Riggs stock was additional consideration. The Tax Court accordingly held that the Riggs assets were not obtained "solely for all or a part of its voting stock." We agree.

Bausch & Lomb concedes that to qualify as a "C" reorganization, it could not furnish any additional consideration over and above its own stock. *Helvering v. Southwest Consolidated Corp.,* 1942, 315 U.S. 194; *Adwood Corp. v. Commissioner,* 6 Cir., 1952, 200 F.2d 552, certiorari denied 346 U.S. 818; *Stoddard v. Commissioner,* 2 Cir., 1944, 141 F.2d 76. Moreover, Bausch & Lomb admits, as the correspondence and minutes of pertinent meetings plainly show, that the acquisition of the Riggs assets and the dissolution of Riggs were both part of the same plan. Nevertheless, Bausch & Lomb asserts that the exchange of the Riggs assets for its stock should be treated as separate and distinct from the dissolution. The argument runs to the effect that, if the two steps are viewed apart from one another, a "C" reorganization is effected.

Petitioner contends that, even if a qualification according to the literal terms of Section 112(g) (1) (C) is not found, the amalgamation was in substance a "reorganization" because it has the attributes of one, including "continuity of interest" and business purpose. This is factually not quite true for, while the amalgamation may have been for genuine business reasons, the division into two steps served only to facilitate the liquidation of Riggs. It was considered easier to distribute Bausch & Lomb stock than distribute the Riggs assets. Hence the "business purpose" of dividing the liquidation into two steps lends no support to Bausch & Lomb's contention that in substance and actuality a reorganization was achieved. Moreover, the Congress has defined in Section 112(g)(1)(C) how a reorganization thereunder may be effected, and the only question for us to decide, on this phase of the case, is whether the necessary requirements have been truly fulfilled. It is for the Congress and not for us to say whether some other alleged equivalent set of facts should receive the same tax free status.

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but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, * * *".

2 Section 112(b)(3) provides:

"(b) *Exchanges solely in kind.*

* * * * * * * * * * * *

"(3) *Stock or stock on reorganization.* No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

Nor does the fact that Bausch & Lomb may well have desired to hold the 84,347 shares of its own voting shares as treasury stock change our opinion of the transaction as a whole.

Bausch & Lomb suggests that under our present holding even if it had but a 1% interest in Riggs, the requirement that the acquisition be "solely for * * * its voting stock" could defeat Section 112(g) (1) (C) reorganization treatment. This hypothesis is a far cry from the facts disclosed in this record, and the lack of controlling interest surrounds it with a mist of unreality. In any event, it will be time to consider such a situation in all its aspects when, as and if it comes before us. We merely hold that the attempt to thwart taxation in this case by carrying out the liquidation process in two steps instead of one fell short of meeting the requirements of a "C" reorganization. See Gregory v. Helvering, 1935, 293 U.S. 465; Helvering v. Alabama Asphaltic Limestone Co., 1942, 315 U.S. 179; Helvering v. Bashford, 1938, 302 U.S. 454; Minnesota Tea Co. v. Helvering, 1938, 302 U.S. 609.

Of course, the fact that Bausch & Lomb "could have" merged with Riggs and hence qualified the transaction as a reorganization under [section 112(g) (1) (A)] is beside the point. For reasons of its own it chose not to do so. This is clearly not an "A" reorganization.

Bausch & Lomb also claims that a tax-free liquidation was effected under Section 112(b) (6) (A),[3] although it plainly lacked the necessary 80% of the voting stock. This belabored effort to claim ownership of the 51 shares of Riggs voting stock for which 12 of Riggs' employees had received credit on Riggs' books, so as to raise Bausch & Lomb's interest slightly above the 80% required by Section 112(b) (6) (A) has nothing whatever to commend it. As found by the Tax Court, Bausch & Lomb never was the legal or equitable owner of these shares, there was never any agreement on the part of the employees to assign them to Bausch

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[3] Section 112(b)(6)(A) of the 1939 Code provides:

"(6) *Property received by corporation on complete liquidation of another.* No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. For the purposes of this paragraph a distribution shall be considered to be in complete liquidation only if—

"(A) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 per centum of the total number of shares of all other classes of stock (excepting nonvoting stock which is limited and preferred as to dividends), and was at no time on or after the date of the adoption of the plan of liquidation and until the receipt of the property the owner of a greater percentage of any class of stock than the percentage of such class owned at the time of the receipt of the property; * * *".

& Lomb, and the original stock purchase agreements of the Riggs employees provided that if Riggs should be reorganized and its business acquired by another corporation, a successor corporation would have the right to assume the contract and substitute its stock in the place of the Riggs' stock originally reserved under the stock purchase agreements. New arrangements were made later, in line with the provision of the original stock purchase agreements just referred to, and the employees received certain cash payments and the 433 shares of Bausch & Lomb stock mentioned in the opening part of this opinion. We find in the facts of this case no foundation whatever for the claim that a liquidation was effected under Section 112(b) (6) (A).

Affirmed.

Note

For detailed consideration of the problem, see Seplow, "Acquisition of Assets of a Subsidiary: Liquidation or Reorganization?" 73 Harv.L.Rev. 484 (1960).

Continuity of Interest

NEVILLE COKE & CHEMICAL CO. v. COMMISSIONER

United States Circuit Court of Appeals, Third Circuit, 1945. 148 F.2d 599.
Certiorari denied 326 U.S. 726 (1945).

GOODRICH, CIRCUIT JUDGE. The question for us in this case is the correctness of the Tax Court's conclusion concerning the Neville Coke & Chemical Company's tax liability for 1936. Two corporations known as the Hillman Coal & Coke Company and W. J. Rainey, Inc., had made advances of money and sold coal on credit to a corporation known as the Davison Coke & Iron Company.[1] In 1932 the debtor corporation was in some financial difficulty and a reorganization was determined upon. The Hillman and Rainey companies subsequently caused the formation of the taxpayer corporation as a step to facilitate reorganization of the Davison company. To the new corporation Hillman and Rainey transferred their claims against or interest in, the debtor. These consisted of "preferred accounts", first mortgage bonds, accounts receivable, notes of the debtor due in three, four and five years without interest,[2] and stock, of various classifications, in the debtor company.

1 In 1936 it amended its charter so as to change its corporate name to Pittsburgh Coke & Iron Company.

2 The four and five year notes bore interest after three years.

The 1932 efforts not having proved sufficient to get the debtor out of its troubles, in 1935 it filed a 77B petition; a plan of reorganization was promptly approved and final decree entered on January 31, 1936. Under the plan the debtor issued new common stock and debenture bonds. Its old bonds were exchanged for debentures and the holders of certain notes, the nature of which is discussed below, got new debentures in the same face amount ($1,129,000) plus 22,580 shares of common stock in the reorganized company.

Two questions of dispute in this Court between Commissioner and taxpayer relate to (1) whether the exchange of the notes for debentures and shares was a tax free transaction; (2) whether the new debentures were properly valued at par. The Tax Court sustained the Commissioner in his determination that the taxpayer had realized a taxable gain in exchanging its notes for the new debentures and shares. It also sustained the Commissioner's determination that the debentures, on date of acquisition, had a value of par, at the same time reducing the Commissioner's valuation on the shares from $5.94 to $5.00 each.

The first question is obviously the critical one; if the taxpayer is right on that, its troubles, so far as this litigation is concerned, are over. . . . The storm center of the controversy here relates to § 112(b)(3). There is no gain or loss recognized if "stock or securities in a corporation . . . are . . . exchanged solely for stock or securities in such corporation . . . ." Were the notes of Davison, which the taxpayer had in its possession, and which it exchanged for debentures and shares of stock issued by the reorganized debtor, "securities" within the wording of the statute? No question has been raised as to the sufficiency of the evidence of obligations issued by the reorganized debtor to qualify under the description of "stock or securities", and the problem is limited to the consideration of what the taxpayer turned in, that is, the notes above mentioned.

What then are "securities" within the meaning of the section? The taxpayer makes a tentative argument that the word ought to be taken in its common, accepted interpretation and that interpretation includes evidence of indebtedness, but he goes on to admit that the Supreme Court has read into the term a meaning differing radically from common interpretation.

It is to be noted that the phrase "stock or securities" appears twice in § 112(b)(3). Once it refers to what a party turns into a corporation being reorganized. The second appearance of the phrase relates to what a recipient takes from the reorganized company as a result of the transaction. We have no reason for thinking that the phrase has a different meaning in either of the two instances and the argument by the taxpayer that it does

differ fails to convince us. Cf. *Lloyd-Smith v. Commissioner of Internal Revenue,* 2 Cir., 1941, 116 F.2d 642, certiorari denied, 1941, 313 U.S. 588.

Most of the decisions seem to have concerned themselves with what was issued to the recipient by the reorganized corporation. In *Pinellas Ice & Cold Storage Co. v. Commissioner of Internal Revenue,* 1933, 287 U.S. 462, the taxpayer was given short term secured notes, maturing in 45, 75 or 105 days, respectively. The Court said that to give an exemption "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes." Was the term "security" then to depend upon the length of time between inception and maturity of the obligation? The courts talked and decided as though length of time were the test. See the discussion and authorities cited in *L. & E. Stirn, Inc. v. Commissioner of Internal Revenue,* 2 Cir., 1939, 107 F.2d 390. Six year bonds were held to be securities by this Court in *Commissioner of Internal Revenue v. Freund,* 3 Cir., 1938, 98 F.2d 201. On the other hand, when the reorganized corporation issued evidence of indebtedness, ten year notes were held to be "securities" sufficient for a tax free transaction in *Burnham v. Commissioner,* 7 Cir., 1936, 86 F.2d 776, certiorari denied, 1937, 300 U.S. 683.

This tendency to measure legal sufficiency on a time basis was noted by the Supreme Court in *Le Tulle v. Scofield,* 1940, 308 U.S. 415. The Court there declared that "the term of the obligations is not material." It drew the distinction between a case where, after the reorganization, the transferee retained a proprietary interest in the enterprise or simply became a creditor.

Did the notes which taxpayer held against Davison Company give it a "proprietary" interest in the enterprise or was it only a creditor? Since *Le Tulle v. Scofield* was decided the Second Circuit has held that short term notes (six months or on demand) which, however, were secured, "were but short term obligations having the character of temporary evidence of debt," as distinguished from "the well known permanent, or simi-permanent, status of long term obligations, which are to be treated as securities within the meaning of that term in § 112(b)(3) . . ." *Commissioner of Internal Revenue v. Sisto Financial Corporation,* 2 Cir., 139 F.2d 253, 255. The set of facts in that case differs from those here in the length of time in which the obligation had to run before maturity. But, it is to be remembered in this connection, the time element is not the determining factor.

The Commissioner's argument is to the effect that the notes in question do not represent a stake in the business of the corporation. Their total amount was $1,129,000. $500,000 was due

in three years, $250,000 in four years and $250,000 in five years. These had been received by the Hillman Company in 1932 in exchange for $500,000 demand notes and $500,000 past due promissory notes which Hillman Company had discounted for the debtor corporation. The remaining $129,000 represented three year notes received by Hillman Company and the Rainey Company in 1932 as current creditors of the debtor. It is pointed out that J. H. Hillman, Jr., of the Hillman Company, testified that the $1,000,000 loaned in 1930 was conditioned upon the debtor giving his Company its business in low volatile coal, thus indicating no intention of investing in debtor's business. The taxpayer, in its reply brief, meets this point with great vigor and considerable force. It calls to our attention the reorganization agreement of 1932 which was not a court proceeding, but an agreement between the Davison Company and its principal creditors. This document is in evidence and it is stipulated that the recital of fact therein contained may be taken as true. In that contract the debtor agreed that certain creditors of the corporation, including representatives of Rainey and Hillman should become members of the debtor's Board of Directors; stockholders of Davison surrendered prerogatives to receive cash dividends; the debtor limited its power to create new obligations. The arrangement in 1932 does indicate a stringent control on the part of the debtor corporation by its chief creditors. Most of those creditors received from the debtor promissory notes of the type held by Hillman and Rainey which were exchanged in the 1935 reorganization proceeding.

The weakness of the taxpayer's argument in this respect is that the taxpayer itself was not a party to this agreement. Provisions making certain creditors directors of the debtor company named specifically representatives of The Koppers Company, Hillman Coal & Coke Company, W. J. Rainey, Inc., and M. A. Hanna Company. The taxpayer, as the assignee of the notes given by the debtor to Hillman Company and others, did not succeed to this right of control of the debtor because it became the possessor of the promissory notes. While it is true that the taxpayer was set up by two of these creditors for the convenience of reorganization it is, nevertheless, a separate legal entity and will have to take the disadvantages as well as the advantages of such corporate arrangement. Our conclusion is that the agreement of 1932, as a consequence of which the notes were issued, was an arrangement whereby creditors of Davison became very active in its management. But they did so by virtue of the agreement and not as holders of the notes, the issuance of which was one item in the agreement.

There is one further point in this connection. It was stipulated in the reorganization agreement that the notes should contain

a provision giving the holder an option to convert up to 50% of the face amount thereof in prior preferred stock, if the option was exercised within three years. Petitioner contends that this is sufficient in itself to bring the notes into the category of securities and cites *E. P. Raymond v. Commissioner of Internal Revenue*, 1938. 37 B.T.A. 423. There the shareholder turned in his old shares and got back an option to buy new shares in the reorganized company. The taxpayer in the instant case was a creditor who had an option to become a shareholder if it had asked for stock instead of money. The fact that it had a chance to acquire a proprietary interest in its debtor does not change it from a creditor to a security holder, we think, unless and until the option is exercised. . . .

The decision of the Tax Court is affirmed.

Notes

(A) The *Neville* case is discussed in Griswold, " 'Securities' and 'Continuity of Interest,' " 58 Harv.L.Rev. 705 (1945). See also Best, " 'Securities' in Section 112(b)," 28 Taxes 315 (1950); Brookes, "The Continuity of Interest Test in Reorganizations—A Blessing or a Curse?" 34 Calif.L.Rev. 1 (1946); Silverson, "The Meaning of Le Tulle v. Scofield," 18 Taxes 492 (1940); "Continuity of Interest in Reorganization Under the Federal Income Tax," 49 Yale L.J. 1079 (1940).

For a recent summary, see Silverman, "Debt in Corporate Amalgamations," 44 Va.L.Rev. 873 (1958). See also Rev.Rul. 59–98, 1959–1 Cum.Bull. 76.

Insolvency Reorganizations

(B) In *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), a corporation was insolvent. Its noteholders formed a committee which bid in its property at a bankruptcy sale. The assets were then transferred to a new corporation in exchange for its stock, all of which was issued to the noteholders, the old stockholders being eliminated. The Court held that this was a "reorganization" so that the basis of the old corporation carried over to the new for the purpose of determining depreciation and depletion. The continuity of interest test was held to be satisfied since the creditors had effective command over the disposition of the property from the time when they took steps to enforce their demands by the institution of bankruptcy proceedings.

(C) In *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), the mortgage on a corporation's property was foreclosed. The property was transferred to a new corporation in exchange for common stock and stock purchase warrants of the new company. The common stock went mostly to bondholders of the old corporation, but a small part of it, together with part of the warrants, went to the old company's unsecured creditors. The rest of the warrants went to the old company's stockholders.

The Court held that this was not a "reorganization" under what is now clause (C) of sec. 368(a)(1) of the 1954 Code since the property was not acquired by the transferree solely for voting stock. The Court said (p. 198): " 'Solely' leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement." The Court also held that the transaction was not a reorganization under what is now clause (D) of sec. 368(a)(1) since the transferor or its shareholders were not in "control" of the transferee. Although the bondholders had enough interest to meet the continuity of interest requirement, it could not be said that they were "shareholders" of the old company. Finally, the Court held that the transaction was not a "recapitalization," within the present clause (E) of sec. 368(a)(1). It said (p. 202): "There was not that reshuffling of a capital structure, within the framework of an existing corporation, contemplated by the term 'recapitalization.' "

(D) In *Helvering v. Cement Investors, Inc.*, 316 U.S. 527 (1942), a corporation and its wholly owned subsidiary were reorganized in a proceeding under sec. 77B of the Bankruptcy Act. Their assets were transferred to a new company which assumed the bonds of the parent company, and issued income bonds and common stock in exchange for the bonds of the subsidiary company. Stockholders received warrants for the purchase of shares of the new company. The Court held that the transaction was not a reorganization, in accordance with its decision in the *Southwest Consolidated* case. But it held that the transaction came within the provision now found in sec. 351 of the 1954 Code, since the bondholders of the subsidiary were in control of the new corporation immediately after the exchange. Accordingly, no gain was recognized to the old bondholders on the exchange.

(E) Sections 371–373 of the 1954 Code contain specific provisions under which no gain or loss is recognized when corporate property is transferred in receivership, or foreclosure proceedings, or under sec. 77B or Chapter X of the Bankruptcy Act in exchange for stock or securities of the acquiring corporation. The predecessors of these provisions were added in 1943; they apply to all reorganizations occurring after 1933. Corresponding provisions as to basis are included in secs. 372 and 373(b). See Darrell, "Creditors' Reorganizations and the Federal Income Tax," 57 Harv.L.Rev. 1009 (1944).

Assumption of Indebtedness

(F) Section 357 of the 1954 Code contains provisions relating to assumption of liability with respect to property by the acquiring corporation where there has been a transfer under secs. 351, 361 and 371. In such a case, the amount of the indebtedness assumed by the acquiring corporation is to be disregarded in determining whether the transaction meets the requirements of the transfer and reorganization provisions. The forerunner of this provision was inserted in 1939, to overcome the decision in *United States v. Hendler*, 303 U.S. 564 (1938).[1]

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[1] See Surrey, "Assumption of Indebtedness in Tax Free Exchanges," 50 Yale L.J. 1 (1940); Sherman, "Assumption of Debts in Corporate Reorganization," 17 Taxes 691 (1939).

Note that sec. 357(b) makes the provision inapplicable if it appears that the principal purpose of the taxpayer in arranging for the assumption of liability was tax avoidance. Similarly, under sec. 357(c), which is new in the 1954 Code, if the amount of the liability assumed exceeds the basis of the property, then gain is recognized to the extent of the excess. The Committee Reports show that this is designed to apply in such a situation as this: A man has property which cost him $20,000. It goes up in value until it is worth $75,000. The man puts a mortgage on it for $50,000. He then transfers the property to a newly organized corporation in exchange for all of the corporation's stock, and the corporation assumes the liability on the mortgage (or acquires the property subject to the mortgage liability). Under sec. 357 (c), the transferor would have gain on this transfer in the amount of $30,000. For a similar result under the 1939 Code, see *Jack L. Easson,* 33 T.C. 963 (1960).

Definition of a Reorganization

(G) The general definition of the term "reorganization" is contained in sec. 368(a). Under sec. 368(a)(1)(B), one of the requirements is that the exchange be "solely" for voting stock. Consider the situation in *Howard v. Commissioner,* 238 F.2d 943 (C.A.7th, 1956), where it appeared that T, a stockholder in X Corporation, exchanged his X stock for voting stock of Y Corporation pursuant to an agreement under which Y acquired all the stock of X. Under the agreement, Y received 80.19% of the outstanding X shares solely for its own voting stock, but paid cash for the remaining 19.81% of the shares. T received only stock in Y for his X stock. The Commissioner determined that this was not a reorganization, since the stock in X was not acquired by Y solely for Y's voting stock; and this was sustained by the Tax Court. The Court of Appeals reversed, holding that although the acquisition could not qualify as a reorganization, only the stockholders who received cash are taxable on the gain. This might have been a good way to write the statute, but it seems to be an unfortunate confusion or amalgamation of the definition of a reorganization in sec. 368 and the "boot" provisions in sec. 356.

There is a comment on the *Howard* case in 57 Col.L.Rev. 591 (1957).

"Party to a Reorganization"

(H) Section 368(b) contains a definition of the term "party to a reorganization," which is used in secs. 354, 361, and elsewhere. This definition is an outgrowth of the definition formerly contained in sec. 112(g)(2) of the 1939 Code, but is more comprehensive than the former provision.

The earlier provision was involved in *Helvering v. Bashford,* 302 U.S. 454 (1938), where Corporation A wanted to obtain control of Corporations B, C and D. For this purpose, Corporation E was organized, and it acquired all of the stock of B, C, and D. All of the preferred stock and 57% of the common stock of E was issued to A. The shareholders of B, C and D received the rest of the stock in E, some stock in A, and some cash furnished by A. The Commissioner conceded that the stock in E was not taxable. It was held that the stock in A was "other property" within the

provision now found in sec. 356(a) of the 1954 Code, and taxable, since A was not a "party" to the reorganization. See also *Groman v. Commissioner*, 302 U.S. 82 (1937); "Parties to Reorganization under the Revenue Act," 51 Harv.L.Rev. 893 (1938); Lurie, "Namorg—or Groman Reversed," 10 Tax L.Rev. 119 (1954).

The rule of these decisions is changed by sec. 368(b) of the 1954 Code. Under that provision, the corporation in control of the acquiring corporation is a "party to the reorganization." The term also applies now to a corporation controlling the corporation to which the acquired assets are transferred.

(I) Suppose that corporation A is merged into corporation B, or that A is liquidated into B, pursuant to an intercorporate liquidation. Immediately prior to the merger or liquidation, A has an outstanding bad debt reserve. Does A have income as a result of the discontinuance of the reserve in the merger or liquidation?

Cf. Rev.Rul. 57–482, 1957–2 Cum.Bull. 49, and *West Seattle National Bank*, 33 T.C. 341 (1959), both holding that a corporation does have income from the termination of its bad debt reserve, when this is done in connection with a liquidation under sec. 337, despite the provision of that section that "no gain or loss shall be recognized to such corporation from the sale or exchange by it of property" where sec. 337 is applicable.

Basis

COON RUN FUEL CO. v. COMMISSIONER

United States Court of Appeals, Third Circuit, 1954. 209 F.2d 187.

GOODRICH, CIRCUIT JUDGE. This case involves the basis to be used in determining for tax purposes petitioner's gain or loss from sale of its coal land. Petitioner used the cost of the land to a predecessor corporation. The Tax Court held that the correct basis was the purchase price paid for the land at a judicial sale. *Coon Run Fuel Company v. Commissioner*, 20 T.C. 122. If the transaction, or series of transactions, by which the taxpayer acquired the land can rightly be called a "reorganization" within the appropriate statutory provisions,[1] there is no liability for the deficiencies which have been assessed.

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[1] Section 113(a)(7)(12) of the Internal Revenue Code and section 112(i)(1) of the Revenue Act of 1932 are the applicable statutes:

"The basis of property shall be the cost of such property; except that—

* * * * * * * * * * * *

"(7) *Transfers to Corporation.* If the property was acquired—

"(A) after December 31, 1917, and in a taxable year beginning before January 1, 1936, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, or

The facts found by the Tax Court are fully reported in the opinion just cited. Only the essentials will be repeated. LaFayette Coal and Coke Company, a West Virginia corporation, acquired the land in question, its sole asset, in 1907–1908 for the recited consideration of $163,965.00.[2] LaFayette was not an operating company; it merely held the land and paid the annual real estate taxes by means of assessments on its stockholders. After 1926, some shareholders failed to pay these assessments and the corporation was without funds to pay its taxes. As a result, the property was forfeited to the State of West Virginia in 1929, and thus became subject, according to the provisions of West Virginia law, to sale for benefit of the State school fund. Thereafter, petitioner Coon Run Fuel Company, also a West Virginia corporation, was formed by some of the LaFayette shareholders who paid an assessment on their LaFayette shares to Coon Run and surrendered those shares for an equal number in the new corporation. The money raised by this assessment was used to purchase the coal land from the State for $700 and expenses of the sale. This was but a small fraction of the delinquent taxes. Until the judicial sale, LaFayette admittedly retained the right to petition to redeem the land by payment of the delinquent taxes. At this sale, Velma Hudoc, an employee of Alan D. Williams, the Secretary-Treasurer of both corporations, took title and later conveyed to Coon Run.

The Tax Court found as a fact that Mrs. Hudoc took the title to the land on behalf of Coon Run. This crucial finding is challenged by the taxpayer, and must be examined. The record is

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"(B) in a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. * * *

"(12) *Basis established by Revenue Act of 1932.* If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932, 47 Stat. 199, was prescribed by section 113(a)(6), (7), or (9) of such Act, then for the purposes of this chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932."

"(1) The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred * * *." 47 Stat. 169, 198 (1932).

The Revenue Act of 1934, 48 Stat. 680, is also applicable but its pertinent provisions are identical with those of the Act of 1932.

2 The argument for the Commissioner claims that this recital of consideration is insufficient to establish the cost to LaFayette, even if Coon Run is entitled to LaFayette's figure as its own base. We do not reach this question.

rather confusing. There was no stipulation on the point. Mrs. Hudoc was the only witness, Williams having died before the litigation arose. She testified that she acted on behalf of LaFayette. However, she admitted that her recollection was hazy; and she seemed to have no understanding of the separate legal identities of the two organizations. For example, she testified that LaFayette and Coon Run together "make up the corporation." But the letter of October 2, 1931, addressed by Williams to the LaFayette shareholders, indicates that the plan was that Coon Run, not LaFayette, buy the land. More importantly, Williams derived his authority to buy the land (through Mrs. Hudoc) from a resolution passed by the Coon Run shareholders at the annual meeting of that corporation on October 15, 1931. The resolution states that LaFayette had owned the property, that it then belonged to the State, that the land was necessary for the purposes of Coon Run, and that Williams, the Secretary-Treasurer of Coon Run, was authorized to buy it. We agree with petitioner that the foregoing statements are not material to the issue of whether the land did in fact belong to the State, but they are relevant to demonstrate the intent of Williams, the moving force in the matter, that Coon Run be the purchaser. It is noteworthy also that Williams instructed the LaFayette shareholders that the checks for the assessment which made the purchase possible be made payable to Coon Run. It is true that LaFayette joined in Mrs. Hudoc's conveyance to Coon Run. But certainly, in view of the facts just discussed, this conveyance does no more than illustrate that Williams was being exceedingly careful to see that Coon Run got a clear title. We see, therefore, no reason to disagree with the conclusion reached by a trier of fact whose findings are not to be disturbed unless clearly erroneous.

Petitioner argues that, although LaFayette did not redeem the land before the sale, the purchase by Mrs. Hudoc constituted a redemption by operation of law. We are referred to West Virginia statutes and cases governing the rights of a former owner as purchaser at a tax sale. But here the former owner, LaFayette, did not purchase the land; Coon Run bought it.

We come now to the question of whether there has been a reorganization within the terms of the statutes previously cited. The Commissioner argues that part B of section 112(i)(1) of the Act of 1932 is inapplicable because it deals with "a transfer by a corporation * * * to another corporation" and here Coon Run's transferor was the State of West Virginia, not LaFayette. Similarly, the Commissioner maintains that part A is inapplicable because it concerns "the acquisition by one corporation of * * * substantially all the properties of another corporation" and Coon Run has acquired the property of the State of West Virginia, not that of LaFayette.

We agree with both contentions. We assume that LaFayette could have redeemed the property until the time of sale. Also, even though the land was forfeited in 1929, it appears that the State continued to assess real estate taxes against LaFayette until 1931. Therefore, as the Commissioner conceded in argument, the nature of the State's interest in the land before the sale is not crystal clear. However, it is clear from the statute that title was in the State at time of sale and that the former owner's right of redemption was cut off when the sale received judicial confirmation. Coon Run did, then, buy from the State.

Petitioner urges the principle that the old corporation need not be the immediate transferor when the intermediate party is merely a procedural means through which the new corporation acquires the assets of the old. We are directed to *Helvering v. Alabama Asphaltic Limestone Co.,* 1942, 315 U.S. 179; *Palm Springs Holding Corp. v. Commissioner,* 1942, 315 U.S. 185; *Rex Mfg. Co. v. Commissioner,* 7 Cir., 1939, 102 F.2d 325, and similar decisions. In all these cases, however, the intermediary was either a nominee or a creditors committee whose *raison d'être* was the transfer of the assets from the old corporation to the new, or, at any rate, the salvaging of the assets of the old corporation in some manner. In the present situation, the State of West Virginia was certainly no such implement. Its interest was neither a transfer to Coon Run, nor a salvaging of an investment in LaFayette. On the contrary, its interest was recoupment of the delinquent taxes, the very thing the shareholders were attempting to avoid.

In our opinion the situation is analogous to that in *Bondholders Committee v. Commissioner,* 1942, 315 U.S. 189, decided the same day as *Helvering v. Alabama Asphaltic Limestone Co.,* supra. In the Bondholders case, the old corporation conveyed to strangers who later conveyed to the creditors committee. Conforming to the Limestone case, the Court stated that the fact that the property was conveyed to this committee, rather than to the new corporation, did not exclude the transaction from the statute. But it held that the statute "authorizes a carry-over of the basis of the properties in the hands of the 'transferor,' not their basis in the hands of one who may have occupied an earlier position in the chain of ownership." 315 U.S. at page 192 (footnotes omitted).

The decision of the Tax Court will be affirmed.

Notes

Basis to Corporation

(A) In the case of an ordinary reorganization, the basis of the property to the acquiring corporation is determined under sec. 362(b) of the 1954 Code. As the principal case shows, how-

ever, it is necessary that the transaction qualify as a reorganization before this provision applies.

(B) Where the transaction is an insolvency reorganization, and the property is transferred pursuant to an order of a bankruptcy court, then (if the transaction is within sec. 371), the basis provision which applies is that in sec. 372.

Basis to Individuals

(C) Section 358 provides the basis rule as far as the distributee security holders are concerned.

(D) Note the special provision in sec. 1052 of the 1954 Code which governs the basis of property acquired (either by the corporation or by the distributees of securities) where the transaction occurred in some year prior to the adoption of the 1954 Code. In such a case, the basis is in effect determined by the law in force at the time of the transaction (which may well be different from that provided in the present Code), and the basis so determined carries forward, adjusted, of course, as may be required by subsequent events.

CORPORATE DIVISIONS

Sec. 355 of the 1954 Code, and secs. 1.355–1 through 1.355–5 of the Income Tax Regulations

The usual corporate reorganization involves putting something together, either the transfer of old assets to a new corporation, or the combination of the assets or the stock ownership of several previously existing corporations. There is also an area in which the statute now operates with respect to corporate divisions. From 1933 until 1951, there were no such provisions in the statute. The basic provision is now found in sec. 351 of the 1954 Code, carrying forward and expanding provisions which were first enacted in 1951 as secs. 112(b)(11) and 113(a)(23) of the 1939 Code.

Before considering these new provisions, it may be helpful to examine a certain amount of lingo which has developed in this area. It cannot be regarded as official, and is not very important. Nevertheless it may be helpful for the student to distinguish several closely related types of situations, and in that connection to introduce the terms which are applied to them by some tax lawyers.

In all of these cases, we will assume that the A Corporation is conducting two businesses, one a shoe business and the other a candy business. Adequate business reasons exist for whatever is done—otherwise the transaction would not be a reorganization

anyway, under the *Gregory* case. And in each situation there are ample earnings and profits to cover the distribution made.

1. *Split up.* The A corporation may organize two new corporations, the B Company and the C Company. The shoe business is transferred to B, and the candy business to C. The stock of B and C is issued to the shareholders of A in exchange for their shares. On the assumptions made, this is a reorganization under sec. 368(a)(1)(D) of the 1954 Code, and the "exchange" of shares may be tax free under sec. 355, if the requirements of that provision are complied with. There may be reasons why it is undesirable to carry out such a transaction, however. For instance, contracts made by the A corporation (such as a labor contract) would be terminated. There might also be some problems about carryovers or carrybacks of net operating losses. See, however, sec. 381 of the 1954 Code.

2. *Split off.* Instead of carrying out a split up, as defined above, A may retain the shoe business, and transfer the candy business to a new corporation, B. The B shares will be issued to the shareholders of A in exchange for a portion of their A shares, the portion to be determined in strict proportion to the fair market value of the candy business transferred to B and the value of the A shares after the transfer. Although this fits within the language of the statute, someone connected with the Treasury is likely to say that the transaction is either (a) a partial liquidation of A, or (b) a distribution taxable in full under sec. 302(d). The matter is at present unsettled, and will apparently be involved in litigation. A transaction of this sort was found to be a tax free reorganization in *Chester E. Spangler,* 18 T.C. 976 (1952).

3. *Spin off.* Another type of transaction is like the split off, but the B stock is issued to the A shareholders without any exchange, that is, without turning in any of their A shares. In other words, the shareholders keep all of their A shares and get the B shares in addition. This is just what was actually done in the *Gregory* case. From 1933 to 1951, there was no provision in the statute under which such a transaction could be carried out without tax liability. Such a provision is now found in sec. 355.

Note that in all three of these types of transactions the economic effect is exactly the same. In all three the shareholders of A start out owning all of the assets through one corporation (A). In all three they still own all of the assets after the transaction, and no more, and they own them through two corporations. But the tax results may be different.[1]

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[1] For earlier discussions of the question, see Mintz, "Divisive Corporate Reorganizations: Split Ups and Split Offs," 6 Tax L.Rev. 365 (1951); Lowrimore, "The Spin-Off that Spun Off," 28 Taxes 1021 (1950); Barrett, "Split Up and Spin Off Reorganizations," 27 Taxes 113 (1949).

Under the provision now found in sec. 355, "spin-off" reorganizations may come within the non-recognition provisions of the tax laws. For general consideration, see Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 321–356; Palestin, "Tests for Tax-Free Distributions on Corporate Division," 33 Taxes 327 (1960).[2]

REVENUE RULING 59–400

Internal Revenue Service, 1959. 1959–2 Cum.Bull. 114.

Advice has been requested whether a distribution of stock by a corporation engaged in the hotel and real estate businesses qualifies under the nontaxable provisions of section 355 of the Internal Revenue Code of 1954.

M corporation was engaged in two businesses, operating a hotel and renting improved real estate (both commercial and residential). The hotel business was started upon organization in 1920 and has been actively conducted up to the present time. In 1934, *M* corporation also entered into the rental real estate business when it purchased property, constructed a garage and automobile agency facilities thereon and rented it to a dealer. In the intervening years, it acquired other rental properties which it has continued to operate. In 1954, the hotel had a fair market value of 550*x* dollars and a net book value of 350*x* dollars. The rental properties had a fair market value of 305*x* dollars and a net book value of 167*x* dollars.

During the five-year period commencing with 1954, the operation of the hotel business resulted in earnings, after taxes, of 240*x* dollars, and the operation of the real estate business resulted in earnings of approximately 75*x* dollars. In 1958, a new rental office building was built for 400*x* dollars, some 175*x* dollars thereof being provided by loans from banks. At the beginning of 1959, the hotel business was placed in a new corporation *N*, and the stock thereof distributed to the shareholders of *M* on a pro rata basis. *N* corporation received the hotel, plus certain receivables and other hotel business assets. *M* corporation retained the real estate liabilities and assets, which at that time had a net book value of 372*x* dollars and a fair market value of 705*x* dollars.

Section 355 of the Code states, in part, that in order for a distribution of stock to qualify under the nontaxable provisions of

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[2] See also Mintz, "Corporate Separations," 36 Taxes 882 (1958); "Divisive Reorganizations under the Internal Revenue Code of 1954," 67 Yale L.J. 38 (1957); Caplin, "The Five-Year Business Rule for Corporate Operations," 35 Taxes 381 (1957); Caplin, "Corporate Division under the 1954 Code: A New Approach to the Five-Year 'Active Business' Rule," 43 Va.L.Rev. 397 (1957); Pennell, "Divisive Reorganizations and Corporate Contractions," 33 Taxes 924 (1955); Friedman, "Divisive Corporate Reorganizations under the 1954 Code," 10 Tax L.Rev. 487 (1955).

such section, each of the corporations involved must be engaged in a trade or business which has been actively conducted throughout the five-year period ending on the date of distribution, and that the transaction must not be used principally as a device to distribute the earnings and profits of either corporation.

The purpose behind the five-year limitation of section 355 is to prevent the corporate earnings of one business from being drawn off for such a period and put into a new business and thereby, through the creation of a marketable enterprise, convert what would normally have been dividends into capital assets that are readily saleable by the shareholders.

It is the position of the Internal Revenue Service that where a corporation which is devoted to one type of business also engages in the rental business, and substantial acquisitions of new rental property are made within the five-year period preceding the separation of these businesses, a "spin-off" transaction will not qualify under section 355 unless it can be shown that the property acquisitions were substantially financed out of the earnings of the rental business and not out of the earnings of the other business.

From the facts presented herein, it is readily apparent that there has been a very substantial increase in the rental properties subsequent to 1954, primarily as a result of the addition of the large office building in 1958. Further, it is also apparent that, viewing the transaction most favorably to the taxpayer, earnings properly attributable to the hotel business, in the amount of approximately 150*x* dollars, have been employed in increasing the real estate business. In view of this substantial financing out of the earnings of the hotel business, it is held that the distribution of the stock of *N* corporation to the shareholders of *M* corporation will not qualify as a nontaxable distribution under section 355 of the Code.

Notes

(A) For a ruling approving a "spin-off" as a reorganization, see Rev.Rul. 57–126, 1957–1 Cum.Bull. 123.

(B) Is the Treasury justified in its ruling in Rev.Rul. 59–400, above? In the light of this, and the considerable restrictions in sec. 355 itself, can the provision be effectively utilized in situations where it should apply?

(C) The basis provisions of sec. 358 are applicable to distributions made under sec. 355.

(D) In *Edmund P. Coady,* 33 T.C. 771 (1960), it appeared that X Company had for more than five years been engaged in the construction business. It had two shareholders, each with 50% of the stock. There were differences between them, and they agreed to divide the business. A new company was organized, to which half of the assets were transferred, and then the shares in the new company were distributed to the taxpayer in ex-

change for all his stock in X. It was held that this was tax-free under sec. 355, and that the provision of sec. 1.355–1 of the Income Tax Regulations, requiring that the distributing corporation be engaged in two or more separate businesses, is invalid, as going beyond anything required by the statute. Six judges of the Tax Court dissented.

Earnings and Profits After a Reorganization

After the reorganization is carried out, the question may arise as to the effect of the reorganization on the earnings and profits of the successor corporation. Does the successor "buy" all of the assets, so that everything it takes over is "capital," and thus not a part of its earnings and profits? Or are the earnings and profits of the constituent corporation taken over intact by the successor?

The leading case on this question is the *Sansome* case, which is set out below. Indeed, the doctrine of the case—that the earnings and profits are carried over intact—is universally known as the *Sansome* rule. The question actually involved a distribution in liquidation which would not now be treated as a dividend. But it was treated as a dividend under the Revenue Act of 1921 (under which the case arose) if there were earnings and profits. Thus, the question was directly involved, and the *Sansome* case has given its name to its doctrine in the tax law.

COMMISSIONER v. SANSOME

United States Circuit Court of Appeals, Second Circuit, 1932. 60 F.2d 931, Certiorari denied 287 U.S. 667, 1932.

L. HAND, CIRCUIT JUDGE. Sansome, the taxpayer, on January 1, 1921, bought some shares of stock, having $100 par value, in a New Jersey company, which on April 1, 1921, sold out all its assets to another company of the same state. The new company assumed all existing liabilities, and issued its shares to the shareholders of the old, without change in the proportion of their holdings, though the number of new shares was increased five times, and they were without par value. The new charter differed only in that the company could manufacture other products besides silk, to which the charter of the old company had been confined. There was no other change in the "financial structure," as the phrase is.

The old company had carried upon its books a large surplus and undivided profits, which we may assume to have been altogether earned before January 1, 1921, and which the new company carried over at the same figure upon its books for the year, 1921, but somewhat reduced because of losses in 1922. The business made no profit, and the company was dissolved in

1923. During this year Sansome received payments upon his shares in liquidation which the Commissioner included in his returns as dividends for the year 1923, for the distribution of that year did not exhaust the surplus and undivided profits which still remained. Sansome protested; he wishes to use these dividends to compute the "gain" upon his investment; that is, to take all liquidating dividends first to amortize his cost, or "base," and return any overplus as profit in the year, 1924, when the last payment was made. The question is whether section 201 of the Revenue Act of 1921 (42 Stat. 228) justified the Commissioner's position. The Board held that as the companies were separate juristic persons, the later one had distributed nothing "out of *its* earnings or profits."

Section 201 of 1921 differed from the same section in the Act of 1918 (40 Stat. 1059), which expressly provided that all liquidation dividends should be taken as in exchange for shares, and that the gain should be computed by the formula which Sansome wished to use; and the Act of 1924, § 201(c), restored the law to its original form. The change of 1921 must have been deliberate and we cannot disregard it; it is also unequivocal, only distributions not allocated to profits by subdivision b may be used to reduce the subtrahend for computing the gain derived, or the loss sustained. This means that the shareholder is to be taxed upon the dividends as such so far as they represent profits, calculated under the preceding subdivision and that what is left shall be treated as amortizing his cost. The rule would work in some cases to the taxpayer's advantage and in others not; he escapes normal taxes pro tanto, provided he has enough income in later years to use as a deduction the loss calculated upon the reduced payments. *McCaughn v. McCahan,* 39 F.2d 3 (C.C.A.3); *Phelps v. Com'r,* 54 F.2d 289 (C.C.A. 7); *Darrow v. Commissioner,* 8 B.T.A. 276; *Hamilton Woolen Co. v. Commissioner,* 21 B.T.A. 334.

Nor is there doubt as to the constitutionality of the section. When Sansome bought the old shares, the profits had indeed been already earned; yet he might be taxed upon ordinary dividends paid out of them. *U. S. v. Phellis,* 257 U.S. 156, 171, 172; *Taft v. Bowers,* 278 U.S. 470, 484. He could not successfully assert that such dividends must be computed as part of his gain on the transaction, but must be content with a corresponding allowance when he sold. If so, Congress might insist that a dividend in liquidation should be treated like any other, for while this may violate ordinary usage, once we conceive of income as the change from undivided profits to an immediately available dividend, the rest follows. The taxpayer gets his quid pro quo in the closing transaction. Though it is a chance whether the final resultant will be favorable or not, the dice are not loaded against him.

Thus, there was income to tax as much as though the company continued its life; and it was not an unfair method.

All this the Board accepted, but held with Sansome, because it treated the company as new and independent, and the liquidating dividends as distributed out of capital, not "out of its earnings or profits," of which there were none. Under the Act of 1916, which had not yet developed the elaborate definition of the later statutes, greater corporate differences have been considered not to break the identity of the older company. *Weiss v. Stearn*, 265 U. S. 242. In *Marr v. U. S.*, 268 U.S. 536, still greater differences did indeed change the result, but for our purposes the decision is irrelevant for the facts were wide of those at bar. *Western, etc., Co. v. Commissioner*, 33 F.2d 695 (C.C.A. 4), was a stronger case for the petitioner here, and *Phillips v. Lyman H. Howe Films Co.*, 33 F.2d 891 (C.C.A. 3), was substantially on all fours, for we attach no importance to the language of the Pennsylvania statute. In *Pioneer, etc., Co. v. Commissioner*, 55 F.2d 861 (C.C.A. 6), the new company had been organized in a different state, a conceivable distinction (vide *Marr v. U. S.)*, but not enough. Even that is absent here.

However, we prefer to dispose of the case as a matter of statutory construction, quite independently of decisions made in analogous, though not parallel, situations. It seems to us that section 202(c)(2) (42 Stat. 230) should be read as a gloss upon section 201. That section provides for cases of corporate "reorganization" which shall not result in any "gain or loss" to the shareholder participating in them, and it defines them with some particularity. He must wait until he has disposed of the new shares, and use his original cost as the "base" to subtract from what he gets upon the sale. Such a change in the form of the shares is "an exchange of property," not "a sale or other disposition" of them. Section 201 was passed, in some measure at least, to fix what should come into the computation of "gain or loss"; it allowed all payments except those cut out by subdivision *c*. It appears to us extremely unlikely that what was not "recognized" as a sale or disposition for the purpose of fixing gain or loss, should be "recognized" as changing accumulated profits into capital in a section which so far overlapped the later. That in substance declared that some corporate transactions should not break the continuity of the corporate life, a troublesome question that the courts had beclouded by recourse to such vague alternatives as "form" and "substance," anodynes for the pains of reasoning. The effort was at least to narrow the limits of judicial inspiration, and we cannot think that the same issue was left at large in the earlier section. Hence we hold that a corporate reorganization which results in no "gain or loss" under section 202(c)(2) (42 Stat. 230) does not toll the company's life as continued venture

under section 201, and that what were "earnings or profits" of the original, or subsidiary, company remain, for purposes of distribution, "earnings or profits" of the successor, or parent, in liquidation. As the transaction—"reorganization"—between the companies at bar fell plainly within section 202(c)(2), it seems to us that the Board was wrong.

Order reversed; cause remanded for further proceedings in accord with the foregoing.[1]

Notes

(A) In *Commissioner v. Munter,* 331 U.S. 210 (1947), the Supreme Court gave its approval to the *Sansome* rule, and held it applicable to a situation where only 52% of the stockholders of the old company took stock in the new company, the balance of the old stockholders being paid off in cash with money raised through underwriters by sale of stock in the new company to the general public.

This rule is now covered by sec. 381(c)(2)(A) of the 1954 Code, subject to the qualifications there provided.

(B) In *F. R. Humpage,* 17 T.C. 1625 (1952), it was held that the *Sansome* rule would not be applied in the case of a reorganization under Sec. 77B of the Bankruptcy Act. In that case, the Fisher Company had substantial accumulated earnings and profits. It was guarantor on a large bond issue. The principal obligor defaulted, so that the guarantee fell due. The Company was unable to meet this obligation, and filed a voluntary petition for reorganization under Sec. 77B of the Bankruptcy Act. The bankruptcy court approved a plan of reorganization under which a new corporation, the Fisher Corporation, was organized. The new company took over the assets of the old company, and all of the stock of the new company was issued to creditors of the old. Stockholders of the old company were excluded from any participation in the plan.

In 1940, the new company made certain distributions to its shareholders. Since its organization it had sustained net losses. The distributions in 1940 were dividends only if the earnings and profits of the old Fisher Company were carried forward to the new Fisher Corporation under the *Sansome* rule. The Tax Court held (four judges dissenting) that a creditors' reorganization under Sec. 77B of the Bankruptcy Act was to be distinguished from the ordinary "tax free" reorganization, and that the new corporation started out without any accumulated earnings and profits carried forward from the old company.

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[1] With respect to the Sansome problem, see "The Effect of Tax Free Reorganizations on Subsequent Corporate Distributions," 48 Col.L.Rev. 281 (1948); Bierman, "The Treatment of Sansome Earnings and Profits for Equity Invested Capital Purposes," 82 J. of Accountancy 317 (1946).

COMMISSIONER v. PHIPPS

Supreme Court of the United States, 1949. 336 U.S. 410.

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case involves a tax-free liquidation by a parent corporation of some of its subsidiaries. At the time of the liquidation the parent had earnings and profits available for distribution, and the subsidiaries had an aggregate net deficit. The issue now before us is whether the rule of *Commissioner v. Sansome,* 60 F.2d 931, requires the subtraction of the subsidiaries' deficit from the parent's earnings and profits, in determining whether a subsequent distribution by the parent constituted dividends or a return of capital to its stockholders.

The *Sansome* case, *supra,* arose from a tax-free reorganization in which the transferor corporation had a surplus in earnings and profits available for distribution. It was there held that those earnings and profits, for purposes of a subsequent distribution by the transferee corporation to its stockholders, retain their status as earnings or profits and are taxable to the recipients as dividends. The rule has been held to include liquidations of a subsidiary by its parent. *Robinette v. Commissioner,* 148 F.2d 513; U.S.Treas.Reg. 101, Art. 115–11, promulgated under the Revenue Act of 1938 and made retroactive.

The facts were stipulated, and so found by the Tax Court. So far as relevant, they are as follows: In December, 1936, Nevada-California Electric Corporation liquidated five of its wholly owned subsidiaries by distributing to itself all of their assets, subject to their liabilities, and by redeeming and canceling all of their outstanding stock. No gain or loss on the liquidation was recognized for income tax purposes under § 112(b)(6) of the Revenue Act of 1936.[1] On the date of liquidation, one of the subsidiaries had earnings and profits accumulated after February 28, 1913, in the amount of $90,362.77. The four others had deficits which aggregated $3,147,803.62. On December 31, 1936, the parent had earnings and profits accumulated after February 28, 1913, in the amount of $2,129,957.81, which amount does not reflect the earnings or deficits of the subsidiaries. In 1937, Nevada-California had earnings of $390,387.02. In the years 1918 to

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[1] "SEC. 112. RECOGNITION OF GAIN OR LOSS.

"(a) General Rule.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

"(b) Exchanges Solely in Kind.—

"(6) Property Received by Corporation on Complete Liquidation of Another—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. . . ."

1933 inclusive the parent and its subsidiaries filed consolidated income tax returns.[2]

Respondent was the owner of 2,640 shares of the preferred stock of Nevada-California. During 1937 that corporation made a pro rata cash distribution to its preferred stockholders in the amount of $802,284, of which respondent received $18,480. The Commissioner determined that the distribution was a dividend under § 115 of the Revenue Act of 1936 and constituted ordinary income in its entirety.

Of the 1937 distribution, approximately 49% was chargeable to earnings and profits of the taxable year. Consequently, respondent conceded in the Tax Court that that percentage of her share, or about nine thousand dollars, was taxable as a dividend under § 115(a)(2). The Tax Court held in her favor that the balance was not a taxable dividend out of earnings and profits, on the theory that all of Nevada-California's accumulated earnings and profits, plus the accumulated earnings and profits of the subsidiary that had a surplus, were erased by the aggregate deficits of the other four subsidiaries.[3] 8 T.C. 190. The Court of Appeals affirmed by a divided court, 167 F.2d 117. We brought the case here on a writ of certiorari, 335 U.S. 807, because of its importance in the administration of the revenue laws, and because of an alleged conflict of the decision below with that of the Court of Appeals for the Ninth Circuit in *Cranson v. United States,* 146 F. 2d 871.

[The Court here stated and quoted from the *Sansome* case. It continued:] The rule has been consistently followed judicially and has received explicit Congressional approval.[4]

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2 It does not appear in what years occurred the subsidiaries' losses which resulted in their deficits, or to what extent they were set off against the net income of the parent in consolidated return years. To the extent that such set-offs did exist, the basis of the subsidiaries' stock to Nevada-California had been reduced and the losses realized by the parent and availed of for tax purposes prior to the liquidation. U. S. Treas. Reg. 94, Art. 113(b)-1, promulgated under the Revenue Act of 1936.

3 Respondent agrees that the earnings and profits of the subsidiary with a surplus become, by virtue of the Sansome rule, earnings and profits of the parent, whatever the ultimate treatment of the deficits of the other subsidiaries.

4 The Senate Finance Committee Report on § 115(h) of the Revenue Act of 1936, S.Rep.No. 2156, 74th Cong., 2d Sess., p. 19 (1939-1 Cum.Bull. (part 2) 678, 690), recognized the rule of the Sansome case, and said that the amendment made by that Act intended no change in existing law, but was added only in the interest of clarity. U.S.Treas.Reg. 94, Art. 115-11, promulgated under the 1936 Act, incorporates the substance of the report. The Revenue Act of 1938 amended § 115(h) only by extending its application to distributions of "property or money" as well as of "stock or securities"; the effect was to make § 115(h) harmonize with § 112(b)(6) and (7); and Regulations 101, promulgated under the 1938 Act, was amended to conform. The Internal Revenue Code contains the section substantially unchanged.

Section 501 of the Second Revenue Act of 1940 added § 115(*l*) to the Internal Revenue Code, to elaborate the law with regard to the effect of tax-

The rationale of the *Sansome* decision as a "continued venture" doctrine has been often repeated in the cases, and in some of them the fact that the successor corporation has differed from the predecessor merely in identity or form has lent it plausibility. Other cases, however, demonstrate that the "continued venture" analysis does not accurately indicate the basis of the decisions. The rule that earnings and profits of a corporation do not lose their character as such by virtue of a tax-free reorganization or liquidation has been applied where more than one corporation has been absorbed or liquidated, where there has been a "split-off" reorganization, and where the reorganization has resulted in substantial changes in the proprietary interests. . . .

The operation of the *Sansome* rule on the taxation of corporate distributions is brought into high relief by consideration of the economic relation between a parent corporation and its subsidiary. Congress requires that earnings and profits, current or accumulated, be taxed to the recipients thereof as dividends on their distribution. If a subsidiary has a surplus in earnings and profits, the parent has a choice of two methods by which it may "realize" this surplus. It may cause the subsidiary to declare a dividend, or it may liquidate its interest or part of its interest in the subsidiary. In the former case, the distribution would of course be taxable as ordinary income to the parent insofar as that distribution, plus the parent's other income, represented net income to it. If the parent uses the second method, two alternatives again are available: the liquidation may take the form of a sale outright, or may be performed within the framework of the reorganization sections of the Internal Revenue Code or its predecessor acts. If the former, gain is of course realized, and is also recognized for tax purposes. We note in passing, in this connection, that such gain will correspond, if at all, only by coincidence with the amount of earnings and profits of the subsidiary. If the latter, Congress has determined that the gain shall not be recognized at that time, but that such recognition shall be deferred. If the subsidiary has a deficit in earnings and profits, the deficit may be "realized" by the parent only by liquidation, and the same two alternatives are present as when the subsidiary has a surplus: sale, and reorganization within § 112. Again, in the former case, loss is realized and also recognized. And in the case of a reorganization or liquidation in the framework of the Code, the recognition of loss is deferred by Congressional mandate to a later time.

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free distributions on earnings and profits. The reports accompanying the bill in Congress, H.R.Rep.No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum.Bull. 496, 526), and S.Rep.No. 2114, 76th Cong., 3d Sess., p. 25 (1940–2 Cum.Bull. 528, 546–547), both recognize the application of "the principle under which the earnings and profits of the transferor become the earnings and profits of the transferee." Ibid., p. 25. The reports do not mention deficits.

If the assets of the parent and subsidiary are combined via a tax-free reorganization or liquidation, the effect of the *Sansome* rule is simply this: a distribution of assets that would have been taxable as dividends absent the reorganization or liquidation does not lose that character by virtue of the tax-free transaction. Respondent's contention that the logic of the *Sansome* rule requires subtracting the deficit of the subsidiary from the earnings and profits of the parent as a corollary of carrying over the earnings and profits of the subsidiary has a superficial plausibility; but the plausibility disappears when it is noted that the taxpayer thus attempts to obtain an advantage taxwise that would not be available absent the liquidation, since there is no way to "declare" a deficit, and thus no method of loss realization open to the parent parallel to a declaration of dividends as a mode of realizing the profits of a subsidiary.

It is urged upon us that the deficits of the subsidiaries should be subtracted from the earnings and profits of the parent in order to make the tax consequences of the liquidation correspond with the corporate accounting practice. The answer is brief. The *Sansome* rule itself, as applied to earnings and profits, has never been thought to be controlled by ordinary corporate accounting concepts; its uniform effect is to treat for tax purposes as earnings or profits assets which are properly considered capital for many if not most corporate purposes, and it has long been a commonplace of tax law that similar divergences often occur. See *Commissioner v. Wheeler,* 324 U.S. 542, 546; *Putnam v. United States,* 149 F.2d 721, 726; 1 Mertens, *op. cit.* § 9.33; Rudick, *op. cit.* 878–906.[5]

Congress has expressed its purpose to tax all stockholders who receive distributions of earnings and profits. In order to facilitate simplification of corporate financial structures, it has further provided that certain intercorporate transactions shall be free of immediate tax consequences to the corporations. There has been judicially superimposed by the *Sansome* rule, with the subsequent explicit ratification of Congress, the doctrine that tax-free reorganizations shall not disturb the status of earnings and profits otherwise available for distribution. Nevada-Cali-

5 Respondent's brief sets out several hypothetical examples of reorganizations to demonstrate the validity of her contention. Her argument fails to take into account the difference between the concept of surplus or deficit, which is a summary of the operations of the corporation reporting it, and the concept of gain or loss, which reports the effect of the tax-free transaction itself. So various are the possible permutations and combinations of the economic factors that equivalence of surplus or deficit in the accounts of the subsidiary with the gain or loss to the parent would be mere coincidence. Consider for example the case where a corporation acquires all the stock of another which at the time has a large deficit. If the subsidiary is soon liquidated, the deficit will still be large, and the parent may realize little or no loss on the liquidation.

fornia at the time of the 1937 distribution to respondent had such earnings and profits. Since we believe that to allow deduction from these earnings of the deficits of its subsidiaries would be in effect to recognize losses the tax effects of which Congress has explicitly provided should be deferred, the judgment of the Court of Appeals is reversed.

Reversed.

MR. JUSTICE DOUGLAS concurs in the result.

Note

See Rice, "Transfers of Earnings and Deficits in Tax-Free Reorganizations: The Sansome-Phipps Rule," 5 Tax L.Rev. 523 (1950).

The rule of the *Phipps* case is now provided by the statute in sec. 381(c)(2)(B) of the 1954 Code.

In *United States v. Snider,* 224 F.2d 165 (C.A.1st, 1955), the X Corporation, having a deficit in earnings and profits, was reorganized into the Y Corporation. It was held that the Y Corporation had the same deficit of earnings and profits which could be offset against subsequent earnings.

OTHER PROBLEMS

"Boot" in Reorganizations

Sec. 356 of the 1954 Code, and secs. 1.356–1 through 1.356–5 of the Income Tax Regulations

COMMISSIONER v. ESTATE OF BEDFORD

Supreme Court of the United States, 1945. 325 U.S. 283.

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.[1]

. . . This brings us to the merits, which involve the validity of an income tax deficiency assessment for 1937. The case is this. The estate of Edward T. Bedford, who died May 21, 1931, included 3,000 shares of cumulative preferred stock (par value $100) of Abercrombie & Fitch Company. Pursuant to a plan of recapitalization respondent, as executor of the estate, in 1937 exchanged those shares for 3,500 shares of cumulative preferred stock (par value $75), 1,500 shares of common stock (par value $1), and $45,240 in cash (on the basis of $15.08 for each of the old preferred shares). The recapitalization had been proposed because the company, after charging against its surplus account stock dividends totaling $844,100, distributed in 1920, 1928, and

[1] A portion of the opinion, relating to a matter of procedure, is omitted.

1930, had incurred a book deficit in that account of $399,771.87. Because of this deficit, the company, under applicable State law, was unable to pay dividends although for the fiscal year ending January 31, 1937 it had net earnings of $309,073.70.

By comparing the fair market value of the old preferred shares at the date of Bedford's death with the market value of the new stock and cash received the gain to his estate was $139,740. Admittedly the recapitalization was a reorganization, § 112(g)(1)(D) of the Revenue Act of 1936, 49 Stat. 1648, 1681, 26 U.S.C. § 112(g)(1)(E), so that only the cash received, but none of the stock, is taxable. Sections 112(b)(3), 112(c)(1), 49 Stat. 1648, 1679, 1680, 26 U.S.C. §§ 112(b)(3), 12(c)(1). The sole issue is whether the cash, $45,240, is taxable as a dividend, or merely as a capital gain to the extent of 40%. The Tax Court sustained the determination of the Commissioner that the cash was taxable as a dividend, 1 T.C. 478, but was reversed by the Circuit Court of Appeals. 144 F.2d 272. On a showing of importance to the administration of the Revenue Acts, we granted certiorari. 323 U.S. 707.

The precise question is whether the distribution of cash in this recapitalization "has the effect of the distribution of a taxable dividend" under § 112(c)(2) of the Revenue Act of 1936 and as such is fully taxable, or is taxable only at the rate of 40% as a capital gain under § 112(c)(1) of that Act. The relevant provisions read: "(c) *Gain from Exchanges not Solely in Kind.*—(1) If an exchange would be within the provisions of subsection (b), (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. (2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his rateable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

The history of this legislation is not illuminating. Section 112(c)(2) originated in § 203(d)(2) of the Revenue Act of 1924, 43 Stat. 253, 257. But the reports of the Congressional Committees merely use the language of the section to explain it. H.Rep.No. 179, 68th Cong., 1st Sess., pp. 14–15; S.Rep.No. 398,

68th Cong., 1st Sess., pp. 15–16. Nor does the applicable Treasury Regulation add anything; it repeats substantially the Committee Reports. Treas.Reg. 94, Art. 112(g)–4. We are thrown back upon the legislative language for ascertaining the meaning which will best accord with the aims of the language, the practical administration of the law and relevant judicial construction.

Although Abercrombie & Fitch showed a book deficit in the surplus account because the earlier stock dividends had been charged against it, the parties agree that for corporate tax purposes at least earnings and profits exceeding the distributed cash had been earned at the time of the recapitalization. That cash therefore came out of earnings and profits and such a distribution would normally be considered a taxable dividend, see § 115(a),[2] and has so been treated by the courts in seemingly similar situations. It has been ruled in a series of cases that where the stock of one corporation was exchanged for the stock of another and cash and then distributed, such distributions out of earnings and profits had the effect of a distribution of a taxable dividend under § 112(c)(2). *Comm'r v. Owens,* 69 F.2d 597; *Comm'r v. Forhan Realty Corp.,* 75 F.2d 268; *Rose v. Little Inv. Co.,* 86 F.2d 50; *Love v. Comm'r,* 113 F.2d 236; *Campbell v. United States,* 144 F.2d 177. The Tax Court has reached the same result, that is, has treated the distribution as a taxable dividend, in the case of the recapitalization of a single corporation. *McCord v. Comm'r,* 31 B.T.A. 342, 344; *J. Weingarten, Inc. v. Comm'r,* 44 B.T.A. 798, 808–809; *Knapp Monarch Co. v. Comm'r,* 1 T.C. 59, 69–70, affirmed on other grounds, 139 F.2d 863. We cannot distinguish the two situations and find no implication in the statute restricting § 112(c)(2) to taxation as a dividend only in the case of an exchange of stock and assets of two corporations.

Respondent, however, claims that this distribution more nearly has the effect of a "partial liquidation" as defined in § 115(i).[3] But the classifications of § 115, which governs "Distributions of Corporations" apart from reorganizations, were adopted for another purpose. They do not apply to a situation arising within §

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[2] "(a) *Definition of Dividend.*—The term 'dividend' when used in this title (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

[3] "(i) *Definition of Partial Liquidation.*—As used in this section the term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

112. The definition of a "partial liquidation" in § 115(i) is specifically limited to use in § 115. To attempt to carry it over to § 112 would distort its purpose. That limitation is not true of § 115 (a) which defines "dividend" for the purpose of the whole title. Accordingly, this definition is infused into § 112(c)(2). Under § 115(a) a distribution out of accumulated earnings and profits is a "dividend", thus confirming the conclusion that a distribution of earnings and profits has the "effect of the distribution of a taxable dividend" under § 112(c)(2).

Recapitalization does not alter the "effect". Although the capital of a company is reduced, the cash received is a distribution of earnings and profits and as such falls within the federal tax. That the company's treatment of its stock dividends may bring consequences under State law requiring a capital reduction does not alter the character of the transactions which bring them within the federal income tax. Recapitalization is one of the forms of reorganization under § 112(g)(1)(D). It cannot therefore be urged as a reason for taking the transaction out of the requirements of § 112 and forcing it into the mold of § 115. The reduction of capital brings § 112 into operation and does not give immunity from the requirements of § 112(c)(2).

Treating the matter as a problem of statutory construction for our independent judgment, we hold that a distribution, pursuant to a reorganization, of earnings and profits "has the effect of a distribution of a taxable dividend" within § 112(c)(2). As is true of other teasing questions of construction raised by technical provisions of Revenue Acts the matter is not wholly free from doubt. But these doubts would have to be stronger than they are to displace the informed views of the Tax Court. And if the case can be reduced to its own particular circumstances rather than turn on a generalizing principle we should feel bound to apply *Dobson v. Commissioner,* 320 U.S. 489, and sustain the Tax Court.

Reversed.

Note and Problems

(A) See Darrell, "The Scope of Commissioner v. Bedford Estate," 24 Taxes 266 (1946);[1] Wittenstein, "Boot Distributions and Section 112(c)(2): A Re-Examination," 8 Tax L.Rev. 63 (1952); Ayers and Repetti, "Boot Distributions under the '54 Tax Code," 32 Notre Dame Lawyer 414 (1957).

(B) Is it possible, after the *Bedford* case, to have a partial liquidation, or a cash distribution, in connection with a reorganization, without its being taxed as a dividend to the extent of the corporation's earnings and profits? See Holzman, "The Net Economic Effect Test," 38 Taxes 149 (1960).

[1] Comments on the Bedford case may also be found in 45 Col.L.Rev. 799 (1945); 1 Tax L.Rev. 111 (1945).

(C) What is the effect of the distribution in the *Bedford* case on the corporation's earnings and profits? Note that not all of the payment may be taxed as a dividend, since some of the shareholders (or all of them in some cases) may have losses on the exchange, and thus be subject to no tax under the provision that is now found in sec. 356(a).

(D) Is a cash distribution in connection with a reorganization, which is held to "have the effect of the distribution of a dividend," under sec. 356(a)(2), to be regarded as a dividend for other purposes? For example, will it receive the deduction for "dividends received" under sec. 243, or the credit and exemption for "dividends" under secs. 34 and 116? The Treasury has ruled that it will not. See *United States v. E. I. du Pont de Nemours & Co.*, 177 F.Supp. 1, 9 (N.D.Ill.1959), commented on at 45 A.B.A.J. 1319 (1959). See also I.T. 3781, 1946–1 Cum.Bull. 119, where such distributions were ruled not to be within sec. 1441 of the 1954 Code, and thus not subject to withholding of tax at the source when distributed to nonresident alien stockholders.

Carryovers

Secs. 381–382 of the 1954 Code

At various places in the statute, there are a great many provisions which involve some sort of continuity from one year to another. The most obvious of these is the carryover (and carryback) of net operating losses, but there are many others.

In a fairly early case, it was decided that a net operating loss deduction could not be carried forward to a successor corporation, following a reorganization, even though the reorganization was "tax free" under the statute. *New Colonial Ice Co. v. Helvering,* 292 U.S. 435 (1934). This case proceeded on the basis of the separate identity of the corporate entities involved. If there was not a "successor" corporation, but rather a "merger," in which the corporate personality of the old corporation was continued, cases held that there might be a carryforward of net operating loss deduction and unused excess profits credit. See *Stanton Brewery, Inc. v. Commissioner,* 176 F.2d 573 (C.A.2d, 1949), noted in 63 Harv.L.Rev. 897 (1950).[1]

This matter is now covered in great detail by sec. 381 of the 1954 Code, a provision which is new in the new law. Section 381 (a) defines the situations where there is to be continuity between predecessor and successor corporations, and sec. 381(c) lists nineteen different deductions and other items which are to be taken into account by the successor corporation when the conditions of sec. 381(a) are met.

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[1] See "Corporate Reorganization and Continuity of Earning History: Some Tax Aspects," 65 Harv.L.Rev. 648 (1952); McFarland, "Carry-Overs to Continuing Corporations," 28 Taxes 765 (1950); Dane, "Net Operating Loss Carry-Overs and Unused Excess Profits Credits in Tax-Free Reorganizations," 28 Taxes 336 (1950).

Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957), involved a corporation which was organized in 1946. At the same time the same interests organized sixteen other corporations to conduct separate retail stores. All the stock of all the corporations was owned by the same persons in the same proportions. Three of the sixteen corporations had losses in 1948 and the early part of 1949. On August 1, 1949, the sixteen corporations were merged into the taxpayer, which had previously rendered management services for the other companies. It was held that the merged corporation could not take a deduction for a carry-over of net operating loss on account of the losses of the three companies in 1948 and 1949. This case turned on secs. 23(s) and 122 of the 1939 Code. The Court said: "The purpose of these provisions is not to give a merged taxpayer a tax advantage over others who have not merged."

Although this question is now covered by the present statutory provisions, the approach taken by the Court in this case may be of continuing importance. For discussion, see Sinrich, "Libson Shops—Argument against Its Application under the 1954 Code," 13 Tax L.Rev. 167 (1958); Levine and Petta, "Libson Shops; A Study in Semantics," 36 Taxes 445 (1958). See also *F. C. Donovan, Inc. v. United States,* 261 F.2d 470 (C.A.1st, 1958), which allowed a carry-back to the parent for a loss which was sustained after a wholly owned subsidiary was absorbed into its parent corporation.

Acquisition of Loss Corporations

1939 Code

In *Alprosa Watch Corp.,* 11 T.C. 240 (1948), the Esspi Glove Corporation had been in existence for several years prior to June 15, 1943. It used a fiscal year ending on June 30. It had a loss for the portion of the year up to June 15, and also had a loss in the previous fiscal year. On June 15, 1943, all the stock of the company was acquired by new purchasers. They changed the business of the company to that of selling watches. They changed its name to Alprosa Watch Corp.; and its place of business was changed. The Tax Court held that the *Gregory* case was inapplicable, that the corporation remained the same corporation for tax purposes, and that the Alprosa Watch Corporation could deduct the losses which had been sustained while the entity was known as the Esspi Glove Corporation. But in *Commissioner v. British Motor Car Distributors, Ltd.,* 278 F.2d 392 (C.A. 9th, 1960), and in *Mill Ridge Coal Co. v. Patterson,* 264 F.2d 713 (C.A.5th, 1959), the court refused to allow the same corporation to carry forward its own loss, under the 1939 Code, when there had been a change of ownership and a change of business. And

the Tax Court has now accepted this result. *Thomas E. Snyder Sons Co.*, 34 T.C. —— (1960).

See also *The T. V. D. Co.*, 27 T.C. 879 (1957), where it appeared that all the stock of the X Corporation had been acquired by the Bank of America in 1951 on foreclosure. The X Corporation was engaged in the motion picture business. It had been unsuccessful and had substantial losses. In 1952, the X Corporation, with money which it received through a loan from the bank, purchased all the stock of Y Corporation, a successful soap manufacturer. Thereafter, all the operating assets of Y were transferred to X. X then carried on the soap business, from which it derived substantial income. This income was offset by X's previous losses, so that no tax was paid. Y remained in existence, but only for the purpose of liquidating certain assets and paying certain liabilities.

The Commissioner allocated the income from the soap business to Y, purporting to act under secs. 22(a) and 45 of the 1939 Code, corresponding to the general provision of Section 61 and the provision in sec. 482 of the 1954 Code. The Tax Court overruled this determination. It held that Y had nothing to do with the soap business after the transfer, and that there was no basis for allocating any of the income to Y. It held further that Section 129 of the 1939 Code had, by its "unambiguous terms" no application to an "acquired corporation," such as Y. The decision in *Virginia Metal Products, Inc.*, 33 T.C. 788 (1960), is similar, except that the acquired corporation was allowed to use its loss against subsequent income on a consolidated return. See also *A. B. & Container Corp.*, 14 T.C. 842 (1950).

Section 129 of the 1939 Code was the forerunner of the provision now found in sec. 269 of the 1954 Code, to which reference has already been made (p. 437, above).[1]

1954 Code

In the 1954 Code, we have to deal not only with sec. 269, as the successor to sec. 129 of the 1939 Code, but also with sec. 382, which was new in the 1954 Code. The inter-relation of these two provisions is far from clear. See Tarleau, "The Place of Tax Loss Positions in Corporate Acquisitions," in Federal Tax Policy for Economic Growth and Stability (Joint Committee on the Economic Report, 1955) 610. It is clear, though, that sec. 382 prevents the use of carry-overs, even with respect to the same cor-

[1] See Tarleau, "Acquisition of Loss Corporations," 31 Taxes 1050 (1953); Winton, "Carry-Overs and Loss Corporations," 34 Taxes 549 (1956); Ekman, "What Has Happened under Section 129: What May We Expect?" N.Y.Univ. Institute on Fed.Taxation, 10th Annual, p. 1231; Rudick, "Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code," 58 Harv.L.Rev. 196 (1944); Chase, "An Analysis of Section 129 of the Internal Revenue Code," 30 Corn.L.Q. 421 (1945); Barnard, "Acquisitions for Tax Benefit," 34 Calif.L.Rev. 36 (1946).

poration, when there has been a change in the ownership of the company, as specified in sec. 382(a)(1)(A) and (B), and there has been a change in the nature of its trade or business, as specified in sec. 382(a)(1)(C). Sec. 382(b) also contains a provision, similar in purpose, which denies a net operating loss deduction when there has been a substantial change of ownership as a result of a reorganization. Under this provision, there is no requirement that there must also have been a change in the nature of the business.[1]

How would the cases summarized on pages 758 and 759, above, be decided under the 1954 Code?

REVENUE RULING 58-9

Internal Revenue Service, 1958. 1959-1 Cumulative Bulletin 190.

Advice has been requested whether a corporation, which had been inactive but was reactivated in its original line of business during a taxable year in which the percentage ownership of its stock changed to the extent provided in section 382(a) of the Internal Revenue Code of 1954, may avail itself of net operating loss carryovers from taxable years prior to such change in percentage ownership.

The taxpayer corporation, had been engaged in carrying on a general insurance business, but in 1955 ceased to do business because of adverse business factors which resulted in operating losses and in a substantial deficit in its earned surplus account. In 1956, the stockholders of the corporation sold all of the stock in the corporation to an individual engaged in the same type of business. The individual continued to operate his own insurance business, together with the acquired business under the taxpayer's corporate charter.

Section 382(a) of the Code provides, in part, that if one or more of the ten largest unrelated stockholders in a corporation own, at the end of the corporation's taxable year, a percentage of the total fair market value of the outstanding stock as a result of purchase or redemption which is at least 50 percentage points more than such person or persons owned at either the beginning

[1] For discussion, see Germain, "Carryovers in Corporate Acquisitions," 15 Tax L.Rev. 35 (1959); Lent, "Net Operating Loss Carryovers and Corporate Mergers," 11 Tax Exec. 241 (1959); Gemmill, "Loss Corporations," 36 Taxes 105 (1958); Arent, "Current Developments Affecting Loss Corporations," 35 Taxes 956 (1955); Cohen et al., "Carry-overs and the Accumulated Earnings Tax," 10 Tax L.Rev. 277 (1955); Arent, "Tax Aspects of Buying Loss Corporations under the 1954 Code," 33 Taxes 955 (1955); Berger, "Purchase of Loss Companies: Code Section 382(a)," 32 Taxes 876 (1954).

See also Kirkpatrick, "Section 269 of the 1954 Code—Its Present and Prospective Function in the Commissioner's Arsenal," 15 Tax L.Rev. 137 (1960).

of such taxable year or the prior taxable year, and if the corporation has not continued to carry on a trade or business substantially the same as that conducted before the change in percentage ownership of the fair market value of such stock, the net operating loss carryovers of such corporation to such taxable year and subsequent taxable years shall not be included in the net operating loss deduction for such taxable years.

Since the corporation was not engaged in business but was inactive, the reactivation of the corporation after the change in the percentage ownership of the fair market value of its stock, whether or not in the same line of business as that originally conducted, did not put the corporation in a trade or business "substantially the same as that conducted before the change in percentage ownership of such stock," as provided in section 382(a) of the Code.

Accordingly, it is held that a net operating loss carryover of an inactive corporation is not available as a net operating loss deduction for the taxable year in which the percentage ownership of its stock changed to the extent provided in section 382(a) of the Code, and for subsequent taxable years, even though the corporation is reactivated in the same line of business as that originally conducted.

Note

For a comprehensive discussion of these problems, see "Net Operating Loss Carry-Overs and Corporate Adjustments: Retaining an Advantageous Tax History Under Libson Shops and Sections 269, 381, and 382," 68 Yale L.J. 1201 (1960).

Multiplying Corporations

A provision somewhat related to secs. 269 and 382 is found in sec. 1551 of the 1954 Code, carrying forward a rule first enacted in 1951 as sec. 15(c) of the 1939 Code. This is designed to deal with the situation where a number of corporations are used for the purpose of getting the benefit of the surtax exemption (the first $25,000 of the income of a corporation is not subject to surtax), and other benefits of the tax law.[1]

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[1] See "Multiple Incorporation to Obtain Additional Accumulated Earnings Credits and Surtax Exemptions," 44 Minn.L.Rev. 485 (1960); Mortenson, "The Multiple Attack on Multiple Corporations," 35 Taxes 647 (1957); "Some Tax Planning Aspects of Multiple and Divided Corporations," 6 U.C.L.A.L.Rev. 136 (1959); Emmanuel, "Section 15(c): New Teeth for the Reluctant Dragon?" 8 Tax L.Rev. 457 (1953); Landman, "Multiplying Business Corporations and Acquiring Tax Losses," 8 Tax L.Rev. 81 (1952); Landman, "Being Tax-Wise and Otherwise in Multiplying Business Entities," 30 Taxes 893 (1952).

CHAPTER 10

SPECIAL PROBLEMS WITH RESPECT TO CORPORATIONS, ASSOCIATIONS AND PARTNERSHIPS

"Associations" Taxable as Corporations

Sec. 7701(a)(3) of the 1954 Code

MORRISSEY v. COMMISSIONER

Supreme Court of the United States, 1935. 296 U.S. 344.

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

Petitioners, the trustees of an express trust, contest income taxes for the years 1924 to 1926, inclusive, upon the ground that the trust has been illegally treated as an "association." The Circuit Court of Appeals affirmed the decision of the Board of Tax Appeals which sustained the ruling of the Commissioner of Internal Revenue. 74 F.2d 803. We granted certiorari because of a conflict of decisions as to the distinction between an "association" and a "pure trust," the decisions being described in one of the cases as "seemingly in a hopeless state of confusion." *Helvering v. Coleman-Gilbert Associates,* 76 F.2d 191, 193.

The facts were stipulated. In the year 1921 petitioners made a declaration of trust of real estate in Los Angeles. They were to be designated in "their collective capacity" as "Western Avenue Golf Club." The trustees were authorized to add to their number and to choose their successors; to purchase, encumber, sell, lease and operate the "described or other lands"; to construct and operate golf courses, club houses, etc.; to receive the rents, profits and income; to make loans and investments; to make regulations; and generally to manage the trust estate as if the trustees were its absolute owners. The trustees were declared to be without power to bind the beneficiaries personally by "any act, neglect or default," and the beneficiaries and all persons dealing with the trustees were required to look for payment or indemnity to the trust property. The beneficial interests were to be evidenced solely by transferable certificates for shares which were divided into 2,000 preferred shares of the par value of $100 each, and 2,000 common shares of no par value, and the rights of the respective shareholders in the surplus, profits, and capital assets were defined. "Share ledgers" showing the names and addresses of shareholders were to be kept.

The trustees might convene the shareholders in meeting for the purpose of making reports or considering recommendations, but the votes of the shareholders were to be advisory only. The death of a trustee or of a beneficiary was not to end the trust, which was to continue for twenty-five years unless sooner terminated by the trustees.

During the years 1921 and 1922, the trustees sold beneficial interests and paid commissions on the sales. About 42 acres (of the 155 acres described by the declaration of trust) were plotted into lots which were sold during the years 1921 to 1923, most of the sales being on the installment basis. On the remaining property a golf course and club house were constructed, and in 1923 this property with the improvements was conveyed to Western Avenue Golf Club, Inc., a California corporation, in exchange for its stock. Under a lease from the corporation petitioners continued the operation of a golf course until January 12, 1924. After that date petitioners' activities were confined to collections of installments of principal and interest on contracts of purchase, the receipt of interest on bank balances and of fees on assignments by holders of purchase contracts, the execution of conveyances to purchasers, the receipt of dividends from the incorporated club, and the distribution of moneys to the holders of beneficial interests. On December 31, 1923, the total number of outstanding beneficial interests was 3016 held by 920 persons; by December 31, 1926, the number of interests had been gradually decreased to 2172, held by 275 persons. The holdings by the trustees ranged approximately from 16 to 29 per cent.

Petitioners contend that they are trustees "of property held in trust," within section 219 of the Revenue Acts of 1924 and 1926, and are taxable accordingly and not as an "association." They urge that, to constitute an association, the applicable test requires "a quasi-corporate organization in which the beneficiaries, whether or not certificate holders, have some voice in the management and some control over the trustees and have an opportunity to exercise such control through the right to vote at meetings"; and that, in any event, the activities in which petitioners were engaged, during the tax years under consideration, did not constitute "a carrying on of business" within the rule applied by this court.

The Government insists that the distinction between associations and the trusts taxed under section 219 is between "business trusts on the one side" and other trusts "which are engaged merely in collecting the income and conserving the property against the day when it is to be distributed to the beneficiaries"; that Congress intended that all "business trusts" should be taxed as associations.

1. The Revenue Acts of 1924 and 1926 provided:

"The term 'corporation' includes associations, joint-stock companies, and insurance companies." (1924, sec. 2(a)(2); 1926, sec. 2(a)(2)).

A similar definition is found in the earlier Revenue Acts of 1917 (sec. 200), 1918 (sec. 1), and 1921 (sec. 2(2)), and also in the later Acts of 1928 (sec. 701(a)(2)), 1932 (sec. 1111(a)(2)), and 1934 (sec. 801(a)(2).

The Corporation Tax Act of 1909, which imposed an excise tax upon the privilege of doing business in a corporate capacity, embraced associations having a capital stock represented by shares and "organized under the laws of the United States or of any State or Territory. *Flint v. Stone Tracy Co.,* 220 U.S. 108, 144; *Eliot v. Freeman,* 220 U.S. 178, 186. The Income Tax Act of 1913, taxed the net income of "every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships." The case of *Crocker v. Malley,* 249 U.S. 223, arose under the latter Act. The Court found that the declaration of trust in that case, relating to mill property, was on its face "an ordinary real estate trust of the kind familiar in Massachusetts," and that the function of the trustees was "not to manage the mills but simply to collect the rents and income of such property as may be in their hands, with a large discretion in the application of it, but with a recognition that the receipt holders are entitled to it subject to the exercise of the powers confided to the trustees." The Court thought that, if it were assumed that the words "no matter how created or organized" applied to "association," still it would be "a wide departure from normal usage" to call the beneficiaries a joint-stock association when they were not partners and had "no joint action or interest and no control over the fund." Nor could the trustees "by themselves" be treated as a joint-stock association within the meaning of the Act "unless all trustees with discretionary powers are such." *Id.,* pp. 232–234.

The decision in *Crocker v. Malley* was rendered in March, 1919, and the Treasury Department thereupon assumed that the degree of control exercised by the beneficiaries over the management of the trust was determinative of the question whether the trust constituted an "association." . . . It was in that view that the Regulations under the Revenue Acts of 1918 and 1921, in distinguishing an "association" from a "trust," provided as follows:

"If, however the *cestuis que trust* have a voice in the conduct of the business of the trust, whether the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute." Regulations Nos. 45, 62, Art. 1504.

This ruling continued until our decision in May, 1924, in *Hecht v. Malley*, 265 U.S. 144, and furnished the test which the Board of Tax Appeals theretofore applied. Accordingly, the Board in the case now before us, holding that under the trust instrument the shareholders "had no control over the trustees or the management of the business," determined that the trust was taxable as such, and not as an association, for the years 1921, 1922 and 1923.

. . .

In the *Hecht* case, the trustees of the Hecht and Haymarket trusts relied strongly upon the decision in *Crocker v. Malley* as conclusively determining that those trusts could not be held to be associations, unless the trust agreements vested "the shareholders with such control over the trustees as to constitute them more than strict trusts within the Massachusetts rule." Reviewing the reasoning of that decision, we pointed out that it was not authority for the broad proposition advanced. We concluded that, when the nature of the trusts was considered, as the petitioners were "not merely trustees for collecting funds and paying them over," but were "associated together in much the same manner as the directors in a corporation for the purpose of carrying on business enterprises," the trusts were to be deemed associations within the meaning of the Act of 1918. This was true "independently of the large measure of control exercised by the beneficiaries." And we rejected the view that Congress intended that organizations of that character "should be exempt from the excise tax on the privilege of carrying on their business merely because such a slight measure of control may be vested in the beneficiaries that they might be deemed strict trusts within the rule established by the Massachusetts courts."

Following this decision, the Treasury Department amended its regulation so as to provide that the distinction between an association and a trust should no longer depend upon beneficiary control. . . .

2. As the statute merely provided that the term "corporation" should include "associations," without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction. Nor can this authority be deemed to be so restricted that the regulations, once issued, could not later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision. Compare *Murphy Oil Company v. Burnet,* 287 U.S. 299, 303–307. We find no ground for the contention that by the enactment of the Revenue Act of 1924 the Department was limited to its previous regulations as to associations. And, while the case of *Hecht v. Malley* was concerned with the special excise tax provision of the Revenue Act of 1918, the ruling of the Court that the degree of the control by bene-

ficiaries was not a decisive test in that relation could by similar reasoning be applied to the general income taxes laid by the revenue acts upon corporations and thus upon associations. . . .

3. "Association" implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust—whether created by will, deed, or declaration—by which particular property is conveyed to a trustee or is to be held by the settlor, on specified trusts, for the benefit of named or described persons. Such beneficiaries do not ordinarily, and as mere *cestuis que trust,* plan a common effort or enter into a combination for the conduct of a business enterprise. Undoubtedly the terms of an association may make the taking or acquiring of shares or interests sufficient to constitute participation, and may leave the management, or even control of the enterprise, to designated persons. But the nature and purpose of the cooperative undertaking will differentiate it from an ordinary trust. In what are called "business trusts" the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains. Thus a trust may be created as a convenient method by which persons become associated for dealings in real estate, the development of tracts of land, the construction of improvements, and the purchase, management and sale of properties; or for dealings in securities or other personal property; or for the production, or manufacture, and sale of commodities; or for commerce, or other sorts of business; where those who become beneficially interested, either by joining in the plan at the outset, or by later participation according to the terms of the arrangement, seek to share the advantages of a union of their interests in the common enterprise.

The Government contends that such an organized community of effort for the doing of business presents the essential features of an association. Petitioners stress the significance of, and the limitations said to be implied in, the provision classifying associations with corporations.

4. The inclusion of associations with corporations implies resemblance; but it is resemblance and not identity. The resemblance points to features distinguishing associations from partnerships as well as from ordinary trusts. As we have seen, the classification cannot be said to require organization under a statute, or with statutory privileges. The term embraces associations as they may exist at common law. *Hecht v. Malley, supra.* We have already referred to the definitions, quoted in that case, showing the ordinary meaning of the term as applicable to a body

of persons united without a charter "but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise." These definitions, while helpful, are not to be pressed so far as to make mere formal procedure a controlling test. The provision itself negatives such a construction. Thus unincorporated joint-stock companies have generally been regarded as bearing the closest resemblance to corporations. But, in the revenue acts, associations are mentioned separately and are not to be treated as limited to "joint-stock companies," although belonging to the same group. While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive. Thus an association may not have "directors" or "officers," but the "trustees" may function "in much the same manner as the directors in a corporation" for the purpose of carrying on the enterprise. The regulatory provisions of the trust instrument may take the place of "by-laws." And as there may be, under the reasoning in the *Hecht* case, an absence of control by beneficiaries such as is commonly exercised by stockholders in a business corporation, it cannot be considered to be essential to the existence of an association that those beneficially interested should hold meetings or elect their representatives. Again, while the faculty of transferring the interests of members without affecting the continuity of the enterprise may be deemed to be characteristic, the test of an association is not to be found in the mere formal evidence of interests or in a particular method of transfer. . . .

5. Applying these principles to the instant case, we are of the opinion that the trust constituted an association. The trust was created for the development of a tract of land through the construction and operation of golf courses, club houses, etc. and the conduct of incidental businesses, with broad powers for the purchase, operation and sale of properties. Provision was made for the issue of shares of beneficial interests, with described rights and priorities. There were to be preferred shares of the value of $100 each and common shares of no par value. Thus those who took beneficial interests became shareholders in the common undertaking to be conducted for their profit according to the terms of the arrangement. They were not the less associated in that undertaking because the arrangement vested the management and control in the trustees. And the contemplated development of the tract of land held at the outset, even if other properties were not acquired, involved what was essentially a business enterprise. The arrangement provided for centralized control, continuity, and limited liability, and the analogy to corporate organization was carried still further by the provision for the issue of transferable certificates.

Under the trust, a considerable portion of the property was surveyed and subdivided into lots which were sold and, to facilitate the sales, the subdivided property was improved by the construction of streets, sidewalks and curbs. The fact that these sales were made before the beginning of the tax years here in question, and that the remaining property was conveyed to a corporation in exchange for its stock, did not alter the character of the organization. Its character was determined by the terms of the trust instrument. It was not a liquidating trust; it was still an organization for profit, and the profits were still coming in. The powers conferred on the trustees continued and could be exercised for such activities as the instrument authorized.

The judgment is affirmed.

. . .

Affirmed.

Problem and Note

(A) Does this case mean that any trustee who is carrying on business, such as subdividing land or operating an apartment house, is taxable as a corporation? See *A. A. Lewis & Co. v. Commissioner,* 301 U.S. 385 (1937). Cf. *Rohman v. United States,* 275 F.2d 120 (C.A.9th, 1960), where it was held that there was no "association," because there was not sufficient "centralized management." Suppose a business trust is organized with transferable shares and broad powers to carry on business activities, but in fact all it does is to hold title to property and collect and distribute the rents. Is it taxable as a corporation? See *Helvering v. Coleman-Gilbert Associates,* 296 U.S. 369 (1935).

For general consideration, see Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 24–40.[1]

(B) In *United States v. Kintner,* 216 F.2d 418 (C.A.9th, 1954), it was held that a group of doctors practising together were an association, and thus taxable as a corporation. There were eight doctors, who had the entire beneficial interest, and thirty other employees. The association established a pension plan covering the doctors. This would not have been possible if the organization was a partnership, since the doctors would not in that case have been "employees." The case seems a doubtful one, since, if sound, it would seem to mean that such group medical practice is subject to tax on the corporate basis.

The Treasury first announced that it would not follow the *Kintner* decision. Rev.Rul. 56–23, 1956–1 Cum.Bull. 598. Later it ruled that "the usual tests" would be applied in such cases. Rev.Rul. 57–546, 1957–2 Cum.Bull. 886. For general considera-

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[1] See Sneed, "More about Associations in the Oil and Gas Industry," 33 Tex.L.Rev. 168 (1954); Taubman; "The Land Trust Taxable as an Association," 8 Tax L.Rev. 103 (1952); Smith, "Associations Classified as Corporations under the Internal Revenue Code," 34 Calif.L.Rev. 461 (1946); Flagg, "Associations Taxable as Corporations," 13 Tax Mag. 589 (1935); "The Taxation of Investment Trusts as Associations," 51 Yale L.J. 338 (1941).

tion, see Edwards, "Unincorporated Associations and the Medical Profession," 30 Miss.L.J. 293 (1959); Saltz, "Associations," 38 Taxes 187 (1960).

Would this decision apply to law partnerships?

Partnerships

Secs. 701–771 of the 1954 Code

COMMISSIONER v. ESTATE OF GOLDBERGER

United States Court of Appeals, Third Circuit, 1954. 213 F.2d 78.

STALEY, CIRCUIT JUDGE. In 1944 the estate of Norman S. Goldberger received $108,453.59 as a result of a judgment recovered in the United States District Court for the Southern District of New York. That receipt gave rise to these cases, the Commissioner having assessed income tax deficiencies for the year 1944 against both the estate and the beneficiary of a trust set up by Goldberger's will. The Tax Court[1] held that there was no deficiency as to the estate but that the recovery, minus certain deductions, was income to the beneficiary.

The facts were stipulated and were found accordingly by the Tax Court.

In 1933 Goldberger entered into a joint venture with Bauer, Pogue & Co., Inc., a brokerage company, and George E. Tribble. The purpose of the venture was to trade in the stock of Fidelio Brewery, Inc. Each of the venturers contributed a substantial number of Fidelio shares, and Bauer, Pogue & Co., Inc., were the managers of the trading account. By the terms of the agreement, Goldberger was to receive $\frac{50}{115}$ths of the net profits of the venture, which was active from June 8 to August 2, 1933. In September of that year, an accounting was rendered to Goldberger which showed that his share of the net profits of the venture was $71,847.58. This sum was paid to him. He died in 1936, believing that the accounting rendered in 1933 was correct. In 1939 his executrix, petitioner Trounstine, discovered that Bauer, Pogue & Co., Inc., had not dealt honestly with Goldberger in 1933. Trounstine brought suit in New York against Bauer, Pogue & Co., Inc., and Bauer, individually, for an accounting of the joint venture profits. Following removal of the suit, the district court found that, during the operation of the joint venture and in violation of its terms, Bauer, Pogue & Co., Inc., and Bauer and Pogue, individually, secretly traded in Fidelio shares and failed to account to Goldberger for the profits of those sales. After an accounting before a special master, the court found that

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1 18 T.C. 1233 (1952).

in addition to the sum paid to Goldberger in 1933, he should have received $60,163.73. Final judgment was then entered in favor of the estate.[2] In 1944 the estate received, in satisfaction of the judgment, $108,453.59, which included the $60,163.73 which Goldberger should have received in 1933, plus interest from August 11, 1933, and costs and disbursements. Expenses of the litigation amounted to $64,855.02, leaving a net recovery of $43,598.57.

Petitioner Trounstine is Goldberger's widow and the executrix of his estate. His will left his entire residuary estate in trust for his widow. The trustees were to pay to her all income from the res (with an irrelevant exception), and, if any year's income was less than $12,000, a sufficient amount from corpus to make a total annual payment of $12,000. Prior to receipt of the proceeds of the judgment, Goldberger's entire residuary estate, aggregating $79,272.61, had been paid over to her as trust beneficiary. The net recovery was deposited in an account maintained by her as ancilliary executrix between December, 1944, and February, 1945. Between February and May of 1945, that amount was transferred to her domiciliary executrix account, and was transferred to her, individually, between March and May of 1945.

The estate did not file a return for 1944, and Trounstine's 1944 return did not report any of the amount received on the recovery. The Commissioner assessed deficiencies against both the estate and Trounstine and a 25 per cent penalty against the estate for failure to file a return. On petitions for redetermination the Tax Court held that the recovery was gross income to the estate in 1944 but that it was entitled to deduct the litigation expenses and the net amount of the recovery, the latter because it was held to be currently distributable to Trounstine as trust beneficiary. This left no net income to the estate and taxed the net recovery to Trounstine. The result was a determination of no deficiency against the estate, rendering moot the penalty for failure to file, but a deficiency as to Trounstine larger than that assessed. The latter is the petitioner in No. 11,110, and the Commissioner has filed a protective petition for review in No. 11,077.

The Commissioner supports his deficiency assessments by pointing to the general rule that the taxability of the principal amount of recovery in a law suit depends upon the nature of the claim and the basis of recovery. If the claim is for lost profits, the recovery is a taxable gain because it is in lieu of what would

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[2] The final judgment is not reported. The interlocutory judgment directing an accounting appears at 44 F.Supp. 767 (S.D.N.Y., 1942), aff'd 144 F.2d 379 (C.A.2), cert. denied 323 U.S. 777 (1944).

have been taxable had it been received without a law suit. If the claim is for loss of, or damage to, capital, the recovery is nontaxable because it is a return of capital. Here, the principal sum recovered was the amount of joint-venture profits wrongfully withheld from Goldberger and, therefore, we are told there was taxable income. The taxpayers argue, correctly we believe, that the principal sum was taxable income to Goldberger in 1933 and is now beyond reach of the fisc because of the statute of limitations.

The Revenue Act of 1932 governs this phase of the case. Its Section 1111(a)(3)[3] includes a joint venture within the meaning of the term "partnership." Thus, for simplicity's sake, we will use partnership language here. That Act treated the firm and the individual partners substantially as does the present Code. That is, for income tax purposes, the common law, aggregate theory prevailed. The firm was not a taxable entity; its return was informational only. Sections 181 and 189. Its net income was computed, except as to the deduction for charitable contributions, in the same manner as that of an individual. Section 183. The tax was imposed upon the individual partner, who must include, in computing his net income, his distributive share of the firm's net income, whether or not distributed to him.[4] That is the determinative point here. The joint venture made certain profits in 1933, but Goldberger did not receive his entire share. By the express words of Section 182(a), however, that nonreceipt makes no difference taxwise. Once the joint venture realized net income, Goldberger became taxable upon his distributive share, in spite of the fact that he did not actually receive it in that year. This court so decided in *First Mechanics Bank v. Commissioner*, 91 F.2d 275 (C.A. 3, 1937), on facts which are on all fours with those of this case. There, the petitioner's decedent was a member of a joint venture which realized income in 1916. A dispute arose between the venturers, and the decedent did not receive any of his share until 1928, and that in a compromise amount, pending appeal from a judgment in his favor. This court held that the decedent had realized taxable income in 1916 in the full amount of his distributive share. That holding governs here. Moreover, in *Stoughmen v. Commissioner*, 208 F.2d 903 (C.A. 3, 1953), we held that a partner was taxable, in

3 "§ 1111. Definitions

"(a) When used in this Act—

* * * * * * * * * * * *

"(3) The term 'partnership' includes a * * * joint venture * * * and the term 'partner' includes a member in such * * * joint venture." 47 Stat. 169 et seq. (1932).

4 "§ 182. Tax of Partners

"(a) General rule. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year. * * *" Ibid.

the year of realization by the firm, upon his full distributive share of the firm's net income even though he received very little of his share and was wholly unaware of its existence. On the record in that case, there was every reason to believe that he never would receive his full distributive share. . . .

But, says the Commissioner, all that Goldberger had in 1933 was an inchoate, contingent claim, which is not income. The leading case of *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88 (1936), is relied upon. We think that case and its progeny inapplicable here for the same reason this court held it inapplicable in *First Mechanics Bank, supra* at 279–280. The *Safety Car Heating* case did not involve a partnership or joint venture. Here, the profits were realized by the joint venture in 1933. There was nothing conditional or contingent about their receipt. They were earned and paid in 1933. Goldberger, therefore, was legally entitled to his share of those profits and was taxable on that share although he did not actually receive it in that year. The statute made his nonreceipt irrelevant. The fact that he was deceived and was ignorant of the full extent of the gain did not change the fact that profits had been received in 1933 by the joint venture, and his share was income taxable to him in that year.

Swastika Oil & Gas Co. v. Commissioner, 123 F.2d 382 (C.A. 6, 1951), cert. denied 317 U.S. 639 (1942), and *Parr v. Scofield,* 185 F.2d 535 (C.A. 5, 1950) cert. denied 340 U.S. 951 (1951), relied upon by the Commissioner, do not bear on this case. In those cases there was no partnership or joint venture.

Finally, we think the Commissioner distorts the nature of the 1944 judgment. He argues that what the estate recovered in 1944 never became joint-venture profits in 1933 but were the profits of the individual wrongdoers, made in breach of their fiduciary duty. The opinion and findings of fact in the 1944 action, which are part of the stipulated facts here, and the Tax Court's opinion show, however, that joint-venture profits, made in 1933 but wrongfully withheld from Goldberger in that year, are exactly what the estate recovered in 1944. The fact of their nonappearance on the books of the venture, if it is a fact, is not determinative here, for book entries are "no more than evidential, being neither indispensable nor conclusive." *Doyle v. Mitchell Brothers Co.,* 247 U.S. 179, 187 (1918); *Northwestern States Portland Cement Co. v. Huston,* 126 F.2d 196, 199 (C.A. 8, 1952); *Commissioner of Internal Revenue v. North Jersey Title Ins. Co.,* 79 F.2d 492 (C.A. 3, 1935). Having been so recently convinced in the *Stoughmen* case, *supra,* that Section 182 required that the taxpayer lose there, we remain convinced that that section requires that the taxpayers win here. The Commissioner's brief in that case presents a compelling argument in the taxpayers'

favor here. Thus, although there may be no requirement that the Commissioner argue consistently from case to case, we must decide consistently, so far as we are able. We hold that $60,163.-73, the principal amount of the 1944 judgment, was not taxable income to the estate or Trounstine in 1944 but was income to Goldberger in 1933.

[The remainder of the opinion dealing with the taxability of the interest received, and the deductibility of the expenses of litigation, is omitted.]

We hold that there was no deficiency against either the estate or Trounstine for 1944. The decision of the Tax Court in No. 11,077, entered December 4, 1952, will be affirmed. The decision of the Tax Court in No. 11,110, entered January 19, 1953, will be reversed.

Notes

(A) The provisions found in secs. 701–771 of the 1954 Code relating to partnerships are a considerable expansion over the corresponding sections of the earlier law. They are modelled to a considerable extent on proposals which were made by the American Law Institute and by the Tax Section of the American Bar Association. For a discussion of these proposals, see Jackson, Johnson, Surrey and Warren, "A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners," 9 Tax L.Rev. 109 (1954).

For a comprehensive discussion of partnership problems in the tax law, see Willis, Handbook of Partnership Taxation (1957). See also Ray and Hammonds, "Corporation or Partnership: Tax Considerations," 36 Taxes 9 (1958); Anderson and Coffee, "Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K," 15 Tax L.Rev. 285 (1960).[1]

(B) Sec. 7701(a)(2) of the 1954 Code defines a partnership as including a "syndicate, group, pool, joint venture, or other unincorporated organization," which is not a trust or estate or a corporation. How is the line drawn between a "joint venture" and an "association" such as was involved in the *Morrissey* case?

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1 For further discussion, see Little, "Partnership Distributions under the Internal Revenue Code of 1954," 10 Tax L.Rev. 161 (1955); Young, "Partners and Partnerships under the 1954 Code," 1955 U. of Ill.L.Forum 533; Jenks and Cohn, "The Taxation of Oil and Gas Partnerships," 27 Geo.Wash.L.Rev. 1 (1958); Herzfeld, "Tax Advantages of Partnerships for Property Development," 11 Okla.L.Rev. 393 (1958); Wood, "Tax Problems of Partnerships," 107 J. of Accountancy 33 (Feb. 1959).

BLACK v. LOCKHART

United States Court of Appeals, Eighth Circuit, 1954. 209 F.2d 308.

GARDNER, CHIEF JUDGE. This appeal is from a judgment dismissing appellant's action by which she sought to recover judgment for taxes erroneously collected from her for the taxable year 1949. Appellant is the duly appointed, qualified and acting administratrix of the estate of her deceased husband, Ernest B. Black, while the appellee is the Collector of Internal Revenue for the Sixth District of Missouri. The parties will hereinafter be referred to as they were designated in the trial court.

Plaintiff's husband and N. T. Veatch, Jr., had for many years been associated together either as partners or as employer and employee. They were engineers and in the course of their concerted activities, on January 1, 1937, they entered into a written partnership agreement under which they continued to furnish professional engineering services to various public corporations, including political subdivisions and utility companies throughout the United States. On July 4, 1949, Ernest B. Black, plaintiff's intestate, died necessitating a winding up of the partnership business. In 1949 plaintiff received in her representative capacity certain funds in the course of winding up the affairs of the partnership and the present controversy grows out of the contention on the part of the government that the funds so received were income to the estate of Ernest B. Black, deceased, whereas she contends that they were a part of the purchase price paid her by the surviving partner. The partnership employed the completed contract method of accounting by which all fees and the payment of all expenses incident to any particular job under any particular contract were accumulated until all the work under that particular contract and project had been completed, and all direct expenses, such as salaries, expenses of employees, etc., directly attributable to such job were charged thereto at completion in order that the exact amount of profit might be ascertained at the completion of any contract.

The contract is a very lengthy one containing provisions relative to many contingencies. Paragraph VIII which seems to be of prime importance so far as the issues here involved are concerned provides as follows:

"1. If either party shall die or be adjudicated bankrupt, or insolvent, or take proceedings for liquidation by arrangement or composition with his creditors, the partnership shall thereupon determine as to him, and he or his executors, administrators or assigns, as the case may be, shall have no interest in common with the surviving or other partner or partners in the property of the partnership, but shall be considered in equity as a vendor to the surviving partner for the share in the partnership of the de-

ceased or bankrupt or liquidating or compounding partner as and from the date of his death, or bankruptcy, or insolvency, or of his having compounded as aforesaid, for the price and on the terms to be arrived at under the provisions hereinafter contained.

"2. The method to be used in arriving at the amount due the retiring partner, or his administrators, executors, or assigns, shall be based upon the value of that partner's interest as shown by the books of the partnership as of the effective date of the dissolution, with the following exceptions:

"(a) In figuring the value of the interest of said partner so retiring, the uncompleted contracts shall be handled by the following method:

"By carrying the contracts then held by the partnership to completion so as to arrive at the exact amount of the total fees, and the total direct charges on said contracts, and the consequent loss or profit to be derived therefrom. In determining the amount of the total fees and total direct charges on such contracts, there shall be charged to such contracts a fair proportion of the office overhead during the period of completion based upon the percentage of total office overhead incurred on both old and new contracts which the direct cost of old contracts bears to the direct cost of all contracts handled by the office subsequent to the effective date. There shall be included in the overhead the proportionate share of a monthly salary of the surviving partner not to exceed the last agreed to between the parties as a monthly drawing account.

"(b) Partnership insurance shall be taken into consideration as heretofore set forth.

"(c) All moneys received from charged off accounts, plan deposits forfeited, and other undisclosed assets, shall, when received, be divided equally between the parties.

"(d) Unsecured liabilities and losses on book accounts ascertained after the effective date to be deducted."

Paragraph IX in substance provides that upon retirement (the same would apply in case of death) of a partner, the books were to be closed in the manner provided in the contract and any new business undertaken by the surviving partner was to be recorded in a separate set of books as his individual business; each six months a written accounting was to be had and the surviving partner required to pay the amount as shown by the books of the company as due the retiring partner, less the sum of $2500.00, and the final accounting made of the entire interest of the retiring partner within thirty days after the last contract uncompleted at the effective date shall be completed. There was paid to plaintiff by Veatch, the surviving partner, the sum of $214,-068.13, representing one-half of the net income arising from the completion of the contracts subsequent to the death of Mr.

Black. Plaintiff in her representative capacity filed an income tax return for the year 1949 showing no income. Upon audit the Collector of Internal Revenue determined that the above mentioned amount received by her as representing one-half of the net income arising from completing certain contracts subsequent to the death of Mr. Black constituted income of the decedent's estate and assessed the estate with an income tax of $21,577.38, including interest. Plaintiff paid the tax as so assessed and thereupon brought the present action to recover the amount so paid, contending that it had been erroneously assessed and collected.

Plaintiff contends here, as she did in the trial court, that the amount received by her from the surviving partner, N. T. Veatch, Jr., was not income for the year 1949 but was paid to her in her representative capacity as part of the purchase price of her deceased husband's share of the partnership property.

This contract has already been considered and construed by a number of courts. In the course of winding up the business of the partnership some differences in opinion arose between Mr. Veatch, the surviving partner, and Mrs. Black, the legal representative of her deceased husband, as to certain matters of accounting, and Mr. Veatch brought an action in the Circuit Court of Jackson County, Missouri, against Mrs. Black as Administratrix of her deceased husband's estate, seeking a declaratory judgment. It was there, as here, contended by Mrs. Black that the partnership agreement provided for a sale of the interest of the deceased partner to the surviving partner on the death of either of the parties. On trial the court in disposing of this contention said:

"The partnership agreement dated January 1, 1937 provides for the liquidation of the partnership affairs upon the death of one partner and not for the sale of an interest in the partnership by the estate of the deceased partner to the survivor, and the sums paid and payable to defendant under such agreement are, in fact, a distribution of income accruing from the performance of the contracts held by the partnership prior to the death of E. B. Black and do not represent payments by plaintiff as the purchase price of an interest in the partnership or of any other asset of property."

The case was appealed to the Supreme Court of Missouri where Mrs. Black renewed her contention that the partnership contract provided for a sale of the deceased partner's interest in the partnership property to the surviving partner. The Supreme Court, however, affirmed the decision of the trial court and in the course of its opinion touching this question said:

"What could the purchasing partner gain, if anything, under the uncompleted contracts provisions over a liquidation upon in

good faith completing the uncompleted contracts and paying the retiring partner one-half of the earnings as if he continued a partner? We conclude, as did the trial court, the partners intended a distribution to the deceased partner's estate of earnings on partnership contracts completed after death the same as prior to dissolution and not a sale of earnings for a distributive share; but in either event the surviving partner under the agreement was to have an interest as owner only to his distributive share of the earnings on the uncompleted partnership contracts." Veatch v. Black, 363 Mo. 190, 250 S.W.2d 501, 509.

The State court action, it will be observed, was in effect between the parties to the contract, and as between the surviving partner and the legal representative of the deceased partner the decision of the Supreme Court became final and conclusive. In the instant case the trial court approved and followed the decision of the Supreme Court of Missouri, not on the theory of res judicata, but as a correct determination of the question presented and here involved.

Since the decision of the trial court in the instant case, the Tax Court of the United States has had occasion to construe this particular provision of the contract in a case entitled *Veatch v. Commissioner of Internal Revenue,* in which the opinion was handed down November 30, 1953 (memorandum decision). That court, after quoting paragraphs VIII and IX of the contract, observed inter alia:

"No capital was ever contributed to the partnership either by Black or by petitioner. The only accounts they had with the partnership represented their share of the profits, which were withdrawn, and sometimes overdrawn, from time to time. The partnership had no tangible assets other than furniture, fixtures and tools which were the equipment of the business. There was never any good will carried on the books and the partners did not consider that the partnership had any good will."

Referring to the contention that the contract provided for a sale of the interest of the deceased partner to the surviving partner rather than a dissolution of the partnership, the court said:

"From the entire record we can only conclude that under the partnership agreement of Black & Veatch it was the partners' intention that the partnership be liquidated upon the death of one partner, and they did not intend a sale as determined by respondent. This was also the conclusion of the Supreme Court of Missouri and the trial court of that state when they construed the partnership agreement. The issues before the Missouri state courts did not involve any questions of tax liability, but merely required a determination of property rights stemming from the partnership agreement. The sum paid to the estate by petition-

er was a distribution of partnership income accruing from the completion of contracts held by the partnership at the time of Black's death." . . .

The decision of the trial court in the instant case is in accord with persuasive, if not controlling, precedents. Being of the view that the contentions of the plaintiff are without merit, the judgment appealed from is affirmed.

Note

(A) For discussions of this problem, see Little, "Tax Planning for Professional Partnerships," 35 Taxes 993 (1957); Willis, "Tax Planning of Payments by the Partnership to a Retiring or Deceased Partner," 30 So.Calif.L.Rev. 501 (1957); Little, "Payments by a Partnership to Former Partners or their Estates," 31 Taxes 439 (1953); "The Death of a Partner and the Federal Income Tax," 50 Col.L.Rev. 658 (1950); Cutler, "Income Tax Consequences Following the Death or Withdrawal of a Partner," 28 B.U.L.Rev. 7 (1948). See also Sullivan, "Conflicts between State Partnership Laws and the Internal Revenue Code," 15 Tax L.Rev. 105 (1959).

(B) Could a partnership agreement be drawn so as to provide for the purchase of a deceased partner's interest? If that were done, what would be the tax consequences to the surviving partners? See Swados, "Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement," 26 Fordham L.Rev. 189 (1957); Steinberg, "Funding Stock Redemption Agreements with Life Insurance," 35 Taxes 669 (1957).

(C) Sec. 1361 of the 1954 Code contains a provision under which a partnership or other unincorporated business may elect to be taxed as a corporation. This seems to have been little used. For discussion, see Olenick, "To Be or Not to Be a 1361 Corporation," 38 Taxes 139 (1960).

Insurance Companies

Secs. 801–842 of the 1954 Code, as amended in 1959

The statute contains special provisions for the taxation of insurance companies. They are divided into three groups: (1) Life insurance companies; secs. 801–820. (2) Mutual insurance companies (other than life); secs. 821–823. (3) Other insurance companies; secs. 831–832.

The whole method of taxing life insurance companies was sharply changed by the Life Insurance Company Income Tax Act of 1959, approved June 25, 1959. This repeals old Part I of subchapter L of the 1954 Code, and adds new sections 801–820 in its place. The provisions are very complicated. Life Insurance companies, both stock companies and mutual companies, are now taxed in three "phases." For the first time since 1921, they are now subject to tax on underwriting income, and on capital gains. The effect of the three phases is that they are eventually

taxed on all distributed income, but can keep certain portions of their income to provide against possible future contingencies, without paying full current tax on it.

See Curtis, "Comments on the New Life Insurance Company Income Tax Law," 45 A.B.A.J. 855 (1959).

One of the questions which will almost certainly arise under these provisions is their effect, if any, on tax exempt income, such as interest on state and municipal bonds. A leading decision on this question, under the earlier law is *Helvering v. Independent Life Insurance Co.,* 292 U.S. 371 (1934).

Sections 831 and 832, imposing the tax on insurance companies other than life or mutual, provide an interesting example of an effort to adapt the taxing statutes to the requirements of a particular business. See *Commissioner v. New Hampshire Fire Ins. Co.,* 146 F.2d 697 (C.C.A.1st, 1945).

Corporations Treated as Partnerships—Subchapter S "Small Business Corporations"

In 1958, Sub-chapter S, consisting of **secs. 1371–1377,** was added to the Code. This allows certain closely held corporations to elect to be taxed as if they were partnerships. These corporations are called "small business corporations," but they need not in fact be small, though they must be closely held—having not more than ten shareholders, and only one class of stock.

These sections raise many questions: first, as to when it is desirable to use them; and, second, as to the consequences if they are used. As the provisions are new, few if any of the questions have yet been resolved. For discussion, see Bittker, Federal Income Taxation of Corporations and Shareholders (1959) 402–417; Willis, "Sub-chapter S: A Lure to Incorporate Proprietorships and Partnerships," 6 U.C.L.A.L.Rev. 505 (1959); Meyer, "One Year of Subchapter S," 38 Taxes 105 (1960); Caplin, "Subchapter S vs. Partnership: A Proposed Legislative Program," 46 Va. L.Rev. 61 (1960); Caplin, "Subchapter S and Its Effect on the Capitalization of Corporations," 13 Vanderbilt L.Rev. 185 (1959); Meyer, "Subchapter S Corporations," 36 Taxes 919 (1958); "Subchapter S of the 1954 Code," 33 St. John's L.Rev. 187 (1958); Horwich, "The Small Business Corporation," 37 Taxes 20 (1959); Hoffman, "Let's Go Slow With Tax Option Corporations," 37 Taxes 21 (1959).[1]

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[1] See also Caplan, "Guides to the 1958 Tax Law for the General Practitioner," 33 Conn.L.J. 344 (1958); Roberts and Alpert "Subchapter S: Semantic and Procedural Traps in Its Use; Analysis of Dangers," 10 J.Tax-

Reference has already been made (see p. 401, above) to sec. 1244 of the 1954 Code, allowing the deduction of losses on small business corporation stock, as defined in that section.

Regulated Investment Companies

Secs. 851–855 of the 1954 Code

If an individual makes an investment, he is taxable on the interest or dividends which he receives. If he is the beneficiary of a trust making investments, he is taxable on the income of the trust which is distributable to him, and the trust can deduct the income distributed, so that there is no double tax. However, if several individuals pool their property and put it in a trust for investment purposes, the trust may be an "association" taxable as a corporation. And if they put their property into a corporation, in the absence of special provision, the corporation would be taxed on the income it receives, and the individuals would be taxable on the dividends they receive from the corporation.

In the case of investment trusts (which are often, or usually, corporations) it was felt that it was desirable to eliminate the double tax in cases where substantially all of the income is currently distributed. In other words these organizations are taxed very much as if they were trusts.

This is accomplished by the special provisions in the statute relating to Regulated Investment Companies. Such companies must be registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (with some exceptions). Under sec. 852 companies which qualify are allowed to deduct the dividends they pay, and a similar deduction is allowed with respect to dividends paid out of capital gains. These distributions are then taxable to the shareholders, and take the same character in their hands that they had when received by the company.

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ation 2 (1959); Palmer, "Tax Free Corporations!" 21 Georgia B.J. 299 (1959); Anthoine, "Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment," 58 Col.L.Rev. 1146 (1958); Rosenfeld, "Tax Savings Through Pseudo Corporation: Proposed Regulations Pose Traps for the Unwary," 98 Trusts & Estates 316 (1959); Polisher & Aaron, "The 1958 Technical Amendments Act—Estate and Gift Tax Changes and Small Business Tax Revisions," 63 Dick.L.Rev. 185, 202–22 (1959); Mickey and Wallick, "Tax-Saving Plans under Subchapter S Now More Reliable as Result of New Regulations," 10 J.Taxation 268 (1959); Note, "Optional Taxation of Closely Held Corporations Under the Technical Amendments Act of 1958." 72 Harv.L.Rev. 710 (1959).

For an economic discussion of the small business problems which in part motivated this amendment, see Keith, "The Impact of Taxation on Small Business," 24 Law & Contemp.Prob. 98 (1959).

Thus, regulated investment companies (like mutual savings banks) are in effect taxed only on their undistributed income. The tax as to these organizations is very much an undistributed profits tax.

The provisions with respect to Regulated Investment Companies were amended by the Act of July 11, 1956, so that such companies can pay the tax on capital gains if they do not distribute these gains to their shareholders. See sec. 852(b) (3) (D) of the Code.

See, generally, Andrews, "Guide to the Administration of Regulated Investment Companies," 35 Taxes 662 (1957).

Western Hemisphere Trade Corporations

Secs. 921 and 922 provide special tax treatment for another group of corporations. A Western Hemisphere Trade Corporation is defined in sec. 921 as a domestic corporation which does all of its business in North, Central or South America or in the West Indies, and derives substantially all of its income from sources without the United States.

Such corporations are entitled to a special deduction under sec. 922. This is designed to encourage the development of trade in the various countries of the Western Hemisphere.[1]

Improper Accumulation of Surplus

Secs. 531–537 of the 1954 Code

For many years, the tax law has contained a special provision imposing tax at a high rate on companies which improperly accumulate their earnings for the purpose of avoiding the surtax on their shareholders. This tax was found in sec. 102 of the 1939 Code (it was sec. 104 in the Acts of 1928 and 1932 involved in the following case). It has been considerably developed and modified in the new provisions in the 1954 Code.

HELVERING v. CHICAGO STOCK YARDS CO.

Supreme Court of the United States, 1943. 318 U.S. 693.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The Board of Tax Appeals sustained the petitioner's determination of deficiences in the respondent's income tax for 1930, 1932,

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[1] See Kline, "The Western Hemisphere Trade Corporation and the Boggs Bill," 38 Taxes 413 (1960); Flynn, "Western Hemisphere Trade Corporations: Quo Vadis?" 12 Tax L.Rev. 413 (1957); Seidman, "Western Hemisphere Trade Corporations as Sales Subsidiaries," 31 Taxes 369 (1953); Tepper and Lotterman, "The Federal Tax Inducements to Western Hemisphere Trade," 31 Corn.L.Q. 205 (1945).

and 1933. The Circuit Court of Appeals reversed the Board's decision. We granted certiorari because of the importance of the questions involved.

The challenged assessment was of the fifty per cent. additional tax imposed by § 104 of the Revenue Acts of 1928 and 1932. The section, which is substantially the same in both statutes, provides, in subsection (a), that if any corporation is formed or availed of for the purpose of preventing the imposition of surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, the additional tax shall be imposed. That the corporation "is a mere holding or investment company," or that the gains or profits are "permitted to accumulate beyond the reasonable needs of the business," is declared, by subsection (b), prima facie evidence of a purpose to avoid the surtax.

The Union Stock Yards & Transit Company of Chicago, hereinafter called Transit Company, was incorporated in 1865 to operate stock yards in Chicago. Its business was profitable. Frederick H. Prince became a stockholder. In 1890 packers, who were the company's principal source of business, threatened to remove their plants from Chicago unless they were given a share in its profits. Due to limitations in its charter, the corporation could not raise funds necessary to buy off the packers. Mr. Prince and other stockholders met the situation by organizing a holding company under the law of New Jersey, The Chicago Junction Railways & Union Stock Yards Company, hereinafter called the New Jersey Company, which acquired all of the capital stock of the Transit Company. The capital structure at organization was 65,000 shares each of preferred and common, all of $100 par. Collateral trusts bonds, secured by Transit Company stock, were issued, of which $14,000,000 were ultimately outstanding. The charter was to expire in 1940. The New Jersey Company came to own all of the stock of the Transit Company, of a railway company, a railroad company, and all beneficial interest in a real estate trust, which themselves, or through subsidiaries, pursued activities collateral to the stock yards' business. By payments in cash and its own bonds it procured from the packers an agreement to maintain the stock yards at their then location for fifteen years.

When this agreement was about to expire the packers presented fresh demands and Mr. Prince was compelled to devise some method of satisfying them. He decided that if he could obtain the cooperation of the largest he need not trouble about the others. To attain this end he organized, in 1911, the respondent, a Maine corporation. He formed a committee which made a proposal to the New Jersey Company's common stockholders that the respondent would purchase their stock by giving them $200

par of its 5% bonds for each share of common stock or, in the alternative, would stamp the stock with the company's agreement to guarantee a 9% dividend upon it; this in consideration that the respondent should be entitled to all of the New Jersey Company's earnings over and above its expenses, interest charges, and the guaranteed dividend on the common. Thus it was intended to draw into the taxpayer's treasury the excess of the New Jersey Company's earnings. Armour & Co. was given 20% of the respondent's stock, Prince retaining 80% of it. In this way Armour was to share in the earnings of the stock yards.

By a decree in a suit under the Sherman Act, Armour was ordered to part with all interest in the stock yards. In consequence Mr. Prince purchased the Armour-held stock for $1,000,000, which sum was loaned to him by the respondent. Thus Prince became the taxpayer's only stockholder and it is conceded that he retained ownership or voting power which gave him sole control of the company to the close of 1933.[1]

By August 1914 the respondent had acquired, in exchange for its bonds, 31,075 common shares of the New Jersey Company and 33,922 shares had been stamped with its guarantee. In 1919 it acquired the three remaining shares. In the period from 1915 to 1933 it organized two small wholly-owned subsidiaries to transact business connected with the stock yards' enterprise, and also organized, and held four-fifths of the capital stock of, a national bank intended to serve the stock yard district.

The respondent in addition to the New Jersey Company common stock acquired by exchange of its own bonds therefor, bought such stock for cash. By December 31, 1929, it had acquired 58,742 of the 65,000 shares outstanding.

As the charter of the New Jersey Company was to expire in 1940, Mr. Prince, at some date not clearly fixed by the testimony, formed the plan of accumulating cash in the respondent's treasury sufficient to pay the debts of the New Jersey Company and liquidate it by that time. To do this it would be necessary to redeem the outstanding preferred stock at par, pay off the $14,000,000 mortgage and over $6,000,000 of fixed obligations of subsidiaries which had been guaranteed by the New Jersey Company. It would also be necessary to purchase 6,258 shares of New Jersey common not then owned. Thus, as of December 31, 1929, the plan involved the expenditure of about $28,000,000 by 1940. If it could be consummated, the taxpayer would then own the entire stock yards enterprise clear of debt other than its own bonds then outstanding in the amount of $3,227,000 due in 1961. That enterprise, treated as a whole, then had cash and liquid as-

[1] He placed some of the stock in trust, retaining voting control.

sets amounting to $21,705,185,[2] and fixed and other assets of a book value of $40,000,000. The bulk of the liquid assets had been drawn up into the respondent's treasury by virtue of the agreement with the New Jersey Company's stockholders.

The respondent's assets December 31, 1929, exceeded its liabilities, including its capital stock, by $19,622,355. From that date to the close of 1933 its earnings were $10,243,373, of which $1,600,000 was paid out in dividends, and $8,643,373 was added to earned surplus.[3]

These are the salient facts. They are stated in greater detail by the Board and by the court below.

The Board reached these conclusions: That the respondent was a mere holding or investment company as defined by § 104, and had not overcome the consequent presumption that its surplus had been accumulated for the purpose of avoiding surtax upon the earnings of Mr. Prince, as sole stockholder; that, although it was more than a mere holding or investment company, its profits had been permitted to accumulate beyond the reasonable needs of the business, and the evidence did not overcome the prima facies which § 104(b) attributes to this fact; and that, without the benefit of the presumptions created by § 104(b), the proofs require the conclusion that the respondent had been availed of for the purpose of accumulating profits beyond its needs for the purpose of avoiding surtax upon its stockholder.

The Circuit Court of Appeals held that, viewing the facts most favorably to the Government, the respondent was not a mere holding or investment company within the meaning of the statute; that, in concluding the company had accumulated profits beyond its reasonable needs, the Board had employed a wrong yardstick in that it had failed to give weight to the controlling purpose of the accumulation, namely, the long range plan to liquidate the New Jersey Company and consolidate all the assets, free of debt, in the respondent; and, finally, that, in purporting to reach its final conclusion without reference to the statutory presumptions, it had allowed them to affect its judgment. Accordingly the court reversed and directed the Board to retry the case in conformity to the court's opinion.

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[2] Including some $2,000,000 of impounded charges not released to Transit Company until 1932 and a working fund claimed by respondent to require $5,000,000.

[3] This item included additional cash on hand of $2,755,931 ($1,800,000 of which was a subordinated deposit in a stock yards bank), loans to subsidiaries and to Mr. Prince, purchases of common and preferred stock of the New Jersey Company and of respondent's own bonds, and other investments, and an investment of $3,573,218 in securities of stock yards banks which needed financial support. Similar subordinations of deposits and bank investments were made by subsidiaries.

The petitioner urges acceptance of the Board's first conclusion that the respondent was a mere holding or investment company. He says that the taxpayer was nothing but a pocketbook for Mr. Prince who, as an individual, managed and controlled the entire enterprise and used the taxpayer merely as a repository of surplus earnings which were intended ultimately to be used for his benefit. We find it unnecessary to consider this contention, since we think the Board's decision may be supported apart from any presumption arising under the terms of the Act.

The respondent was not formed for the purpose of avoiding surtax on its stockholders. No such exaction existed in 1911. Until some effort was made by legislation to reach and tax accumulated and undistributed surplus, the taxpayer's dividend policy was immaterial. Accumulation of profits in its treasury was of no tax significance and, so far as appears, it was otherwise a matter of indifference, legally speaking, whether surplus moneys were allowed to remain in the treasury or were paid in dividends.

The series of acts which sought to discourage such accumulations had its origin in 1913 with the imposition of an additional tax on the shareholder rather than on the corporation.[4] The additional tax was laid on the corporation by the Revenue Act of 1921 and this method was retained in subsequent acts to and including that of 1932.[5] As the theory of the revenue acts has been to tax corporate profits to the corporation, and their receipt only when distributed to the stockholders, the purpose of the legislation is to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable not only for normal but for surtax on the dividends received.

A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice.

The Board, the court below, and the parties in brief and argument have discussed many facts thought to be relevant to the purpose of the accumulation of surplus by the respondent. The

[4] Act of Oct. 3, 1913, ch. 16, 38 Stat. 114, 166–167; Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1072.

[5] Revenue Act of 1921, ch. 136, 42 Stat. 227, 247–248; Revenue Act of 1924, ch. 234, 43 Stat. 253, 277; Revenue Act of 1928, ch. 852, 45 Stat. 791, 814–15; Revenue Act of 1932, ch. 209, 47 Stat. 169, 195. In later revenue acts a different method of accomplishing the purpose has been adopted.

interrelation of the taxpayer and the other corporations involved in the enterprise, the expiration of the New Jersey Company's charter, the policy or obligation of the taxpayer to provide for the payment of the debts of the New Jersey Company and its subsidiaries, the relation of Mr. Prince as officer and active manager of underlying corporations, the financial transactions between him and the respondent, are discussed and arguments pro and con are based thereon in an effort to prove or to disprove the character of the respondent, the necessities of its business, and the nature of the relationship between it and Mr. Prince.

If we eliminate these matters from consideration and treat the respondent as a controller, manager, and, to a large extent the proprietor of the entire enterprise, we think the Board's conclusion of fact has support in the evidence and must be accepted.

The respondent launched its corporate activities with partners and co-investors in the stock yards enterprise. The New Jersey Company, which then embraced the entire business, had a capital investment represented by stock and bonds of not less than $27,000,000. In 1911, when the respondent was organized, the enterprise had a net worth of at least $16,000,000.[6] The respondent, with a paid-in cash capital of $1,000,000, purchased[7] the right to receive the net earnings of the enterprise after the payment of the New Jersey Company's fixed charges, operating expenses, and the guaranteed dividends on its stock. The respondent's goal was the acquisition, by the year 1940, of the interest of all others having any capital share in the enterprise, and the method pursued was to accumulate current earnings[8] so that, by 1940, they would be available for such capital investment. This investment would, of course, redound to the benefit of the holder or holders of the respondent's stock. The situation disclosed is, in legal effect, similar to that presented in *Helvering v. National Grocery Co.,* 304 U.S. 282. There the surplus earnings were invested in securities unrelated to the business in hand and were, and would remain, available for whatever purposes Kohl, the sole stockholder, determined. Here the accumulated earnings became available to the investment purpose and program of Mr. Prince, the sole stockholder of the taxpayer, or for

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6 The net worth was probably some $3,000,000 in excess of the amount named if the actual net worth of subsidiaries is taken into account.

7 When the plan and agreement with respect to New Jersey Company's common stock was in shape to be consummated, the respondent purchased the plan and the rights arising under it for $1,000,000 (its cash capital), and $7,000,000 par value of its own stock arising out of an increase of its authorized stock from $1,000,000 to $8,000,000.

8 The respondent has paid substantial annual dividends, the highest being at the rate of $400,000 per year during the taxable years in question; and Mr. Prince has also received substantial salaries from the respondent and other corporations which were conducting activities of the enterprise.

other purposes as he might determine. By the use of the taxpayer's corporate personality Mr. Prince could plow the earnings of the enterprise into a capital investment which would convert, by 1940, an original capital venture of $1,000,000 into free assets of a value in excess of $60,000,000. And this without the payment of taxes[9] for surtaxes on the bulk of the earnings. Although Mr. Prince denied any purpose to avoid surtaxes, the Board, as in the *National Grocery* case, was free to conclude, upon all the evidence, that such was the purpose.

The respondent's position is that, as the New Jersey Company's charter was to expire in 1940, and as respondent was under what it deemed a moral, and indeed, a legal obligation to pay off the mortgage debts of the New Jersey Company and its subsidiaries and to redeem its outstanding stock, the accumulation of earnings was necessary to the preservation of its business. There are two sufficient answers. Mr. Prince, the sole stockholder, if in receipt of the respondent's earnings, could equally well have done what the respondent proposed to do, that is turn accumulated earnings into invested capital. And the evidence shows that the New Jersey Company's charter could have been renewed in 1940. Continuance or refinancing of such an enterprise on the face of things would have been practicable.

We cannot say that the Board's conclusion that respondent was availed of for the purpose of preventing the imposition of surtax upon its stockholders, through the medium of accumulation of its profits, is without substantial support.

The judgment is reversed.

Notes

(A) The Treasury's views on sec. 102 of the 1939 Code were broadly summarized in T.D. 4914, 1939–2 Cum.Bull. 108.[1] Although this provision has been in the law for a great many years, it was virtually unused until about 1930, and then applied almost exclusively to closely held companies, particularly when they held a large amount of securities. More recently, however, it has been applied to corporations actively engaged in business. See *Trico Products Corp. v. Commissioner,* 137 F.2d 424 (C.C.A.2d, 1943), cert. den. 320 U.S. 799 (1943); *Gibbs & Cox, Inc. v. Commissioner,* 147 F.2d 60 (C.C.A.2d, 1945); *Whitney Chain & Mfg. Co. v. Commissioner,* 149 F.2d 936 (C.C.A.2d, 1945).

(B) Following the tax decision holding Trico Products Corp. liable for the tax under sec. 102 (see paragraph (A), above), a minority shareholder in the company brought a stockholder's

[9] Most of respondent's income consisted of dividends received from domestic corporations which were deductible from its gross income for tax purposes.

[1] This included the statement that returns will be given "close attention" where corporations "have not distributed at least 70 percent of their earnings as taxable dividends."

suit against the directors of the company to hold them liable for the loss they had caused the company by incurring the tax through failing or refusing to pay adequate dividends. This case went to a referee, and was settled after he had filed a report in favor of the shareholder's claim. The case (*Mahler v. Oishei*) is cited and discussed in 61 Harv.L.Rev. 1058 (1948); "Derivative Actions Arising from Payment of Penalty Taxes under Section 102," 49 Col.L.Rev. 394 (1949).

(C) For discussions of the situation under the pre-1954 statute, see Hall, The Taxation of Corporate Surplus Accumulations (1952)—prepared for the Joint Committee on the Economic Report,—reviewed in 67 Harv.L.Rev. 922 (1954), and by William L. Cary in 6 Nat.Tax J. 197 (1953); Economic Effects of Section 102, published by the Tax Institute, Inc., 1951, reviewed in 7 Tax L.Rev. 392 (1952); Buck and Shackelford, "Retention of Earnings by Corporations under the Income Tax Laws," 36 Va.L.Rev. 141 (1950); Millett, "Key Man Life Insurance and Section 102," 1 J.Am.Soc. Chartered Life Underwriters 462 (1947); Lasser and Holzman, "The '102' Cases," 3 Tax L.Rev. 119 (1947); Austin, "Section 102 and Capital Gains," 26 Taxes 302 (1948);[2] Holzman, "Impact of the War's End on Section 102," 24 Taxes 24 (1946).

(D) The tax imposed under secs. 531–537 of the 1954 Code contains several modifications from the earlier law. These include:

(1) The tax now applies only to the portion of the earnings which is unreasonably accumulated (see sec. 535(c)(1)), not to all of the earnings if any part of the accumulation is unreasonable, as under prior law.

(2) A minimum aggregate accumulation of $100,000 is now allowed (sec. 535(c)(2)). This is $60,000 in the case of "a mere holding or investment company." Sec. 535(c)(3).

(3) Dividends paid within 2½ months after the close of the year can be taken into account in determining the year's distributions (see sec. 563(a)).

(4) The burden of proving that an accumulation is unreasonable is put on the Commissioner if the taxpayer follows certain procedural steps (see sec. 534).

(5) Unreasonable accumulation is so defined as to exclude accumulations for "the reasonably anticipated needs" of the business. Sec. 537.

How far these changes will actually work out to be advantageous to corporations which have substantial accumulations remains to be seen.[3]

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[2] Section 102 was amended in 1951 so as to exclude the amount of capital gains in computing the special tax imposed by that section. This amendment is carried forward into sec. 535(b)(6) of the 1954 Code.

[3] See Holzman, The Tax on Accumulated Earnings (1956); Brown, "Division of Retained Earnings to Reflect Business Needs," 35 Taxes 465 (1957); Barker, "Penalty Tax on Corporations Improperly Accumulating Surplus," 35 Taxes 949 (1957); Altman, "Corporate Accumulation of Earnings," 36 Taxes 933 (1958); Berger, "Did the Revenue Act of 1954 Emasculate Section 102 of the 1939 Code?" 33 Taxes 370 (1955). See also Holzman, "The Accumulated Earnings Tax," 32 Taxes 823 (1954); Cohen et al., "Carry-Overs and the Accumulated Earnings Tax," 10 Tax L.Rev. 277 (1955).

(E) The burden of proof provisions in sec. 534 were made applicable to determinations under old sec. 102 with respect to years prior to 1954 by the Act of August 11, 1955, c. 805, sec. 4. In *Pelton Steel Casting Co. v. Commissioner*, 251 F.2d 278 (C.A. 7th, 1958), affirming 28 T.C. 153 (1957), applying sec. 534 of the 1954 Code under this provision, it was held that the burden of proof provision in Section 534 applies only to the question whether "all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business," and that the burden remained on the taxpayer to prove the absence of a purpose to avoid the imposition of surtax upon its shareholders by the failure to distribute earnings or profits accumulated during the taxable year.

(F) For a consideration of the problems from a comparative point of view, see Chommie, "Surtax Avoidance and Extra Taxation of Corporate Earnings in the United States, United Kingdom, and Canada," 12 Tax L.Rev. 279 (1957).

Personal Holding Companies

Secs. 541–547 of the 1954 Code

BIRMINGHAM CORP. v. COMMISSIONER

United States Circuit Court of Appeals, Fifth Circuit, 1943. 138 F.2d 455.

McCORD, CIRCUIT JUDGE. The petition is for review of a decision sustaining a deficiency of $11,904.76 in personal holding company surtax assessed against Birmingham Corporation for the year 1935. The opinion of the Tax Court is reported, 1 T.C. 808.

Birmingham Corporation is a personal holding company. The corporation's five stockholders agreed that there would be no distribution of earnings for the year 1935, and that each shareholder would include his pro rata share of the adjusted net income of the corporation in his individual tax return, thereby allowing the corporation to take advantage of Section 351(d) of the Revenue Act of 1934, which provides that the personal holding company surtax levied by Section 351(a) "shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the 'adjusted net income' of the corporation for such year." Also see Art. 351–7, T.R. 86, 1934.

In returns timely filed each of the corporation's shareholders, except Henry M. Marx, included in their gross income their entire pro rata share of the adjusted net income of the corporation for the year 1935. On February 20, 1936, Henry M. Marx filed a return but did not include his pro rata share of such income. He filed an amended return on March 7, 1936, and again did not

include such income. On March 8, 1936, he was informed by the secretary of the company of the amount of his pro rata share of the adjusted net income. His share was $5,444.67 of the total of $43,997.36. Thereafter, Henry Marx failed and neglected to report and include his share until March 28, 1936, thirteen days after the final day for filing returns, when he filed with the collector a second amended return including his pro rata share of the corporation's adjusted net income for 1935.

We agree with the Commissioner and The Tax Court that the second amended return of Henry M. Marx did not measure to compliance with the requirements of Section 351(d). This section allows a personal holding company to escape the rigors of the surtax levied by Section 351(a) on condition that "all" shareholders include in their gross income their pro rata share of the adjusted net income of the corporation. If any shareholder fails to include his pro rata share of such income, the corporation may not reap the benefits of Section 51(d), but must pay the surtax levied by Section 351(a). Moreover, there is the further strict requirement that such pro rata share must be included by the shareholder "at the time of filing" his return. The "time of filing" of a return means a filing on or before the due date which is, in the absence of a duly granted extension of time, March 15th of the year following the close of the tax year. Sec. 53, Revenue Act of 1934; Arts. 53–1, 53–4, T.R. 86, 1934. The shareholder, Henry M. Marx, had neither applied for nor been granted an extension of time for the filing of his return. His second amended return filed March 28, 1936, thirteen days after the due date, therefore came too late. Under no proper view of the case can it be considered that the inclusion of his pro rata share of the adjusted net income in his second amended return was a timely inclusion—an inclusion "at the time of filing" his return.

In Section 351(d) Congress has by clear and unambiguous language required that certain conditions be complied with before a personal holding company may be relieved of the surtax levied by Section 351(a). The courts have no power to relax these strict requirements of the statute, and although this case on its face appears to be one of hardship caused by the neglect and oversight of only one shareholder, it must be recognized nevertheless that the plain requirements of the statute have not been met. Since these strict requirements were not met, the petitioner must pay the tax. Ita lex scripta est. *Riley Inv. Co. v. Commissioner,* 311 U.S. 55.

The decision of The Tax Court is affirmed.

WALLER, CIRCUIT JUDGE (dissenting). The second amendment to Henry M. Marx's return, filed thirteen days after March 15,

was accepted by the Collector, together with the additional tax due under the amended return. This procedure was in accord with an immemorial policy of the Department (in all situations except where the statute expressly provided otherwise) to permit a taxpayer to seasonably correct errors and oversights in his return. The right of a taxpayer to have his return speak the truth and accurately reflect his income is not only grounded in longstanding policy and precedent but in common honesty and good morals. In the absence of fraud, unreasonable delay, or positive statutory prohibition (such as in capital stock returns) the right to state the truth, if without malice, without giving information to the enemy, or without violating certain confidential relationships, is the prerogative of an American.

It is conceded: (a) That all the stockholders agreed to include in their individual returns their entire pro rata share of the adjusted and undistributed net income of the corporation; (b) that the corporation made a return on that basis; (c) that all stockholders, except Henry M. Marx, accurately and seasonably returned such income; (d) that Henry M. Marx filed an appropriate amendment on March 28; (e) that in April or May of the same year, Henry M. Marx received a request from the Collector of Internal Revenue for an additional surtax in the amount of $80.00 with respect to his amended return, which amount he paid. There was no fraud. There was no intent to evade taxes, but simply a case of being too busy with the problems and perplexities of others to attend to his own.

Sec. 351(d) of the Revenue Act of 1934 does not condition the option upon the filing of a return on or before March 15, but "at the time of filing their returns."

It is my view that an amendment to a return, seasonably filed, which is accepted and the tax demanded and collected thereon, becomes, and is, a part of the original return as fully as if the amendment had been initially included therein. Statutory penalties and interest perhaps could have been imposed under appropriate statutes, but the penalty cannot now be a refusal of the amended return which had been seasonably and honestly filed and accepted. . . .

I dissent against the doing of an injustice which neither the facts, the statutes, nor impelling precedent makes mandatory upon the Court.

Notes

(A) Note the definitions of personal holding company income [1] in sec. 543, and of stock ownership in sec. 544 of the 1954 Code. The provisions with respect to personal holding companies were considerably enlarged in the 1937 Act. See Paul, "The Background of the Revenue Act of 1937," 5 U. of Chi.L.Rev. 41, 58–65 (1937).[2]

(B) *Foreign personal holding companies.* Reference has already been made to the provisions with respect to foreign personal holding companies in secs. 551–557 of the 1954 Code. Under these sections, the income of such a company is taxed directly to domestic shareholders. See also Brainerd, "United States Income Taxation of the Foreign Holding Company," 34 Taxes 231 (1956); Rudick, "Personal Holding Companies Owned by Nonresident Aliens," 1 Tax L.Rev. 218 (1946).

Undistributed Profits Tax

A number of taxes now in effect are in substance undistributed profits taxes. This is most clearly true of the tax on personal holding companies, but it is also true of the tax on unreasonable accumulation of surplus, and of the tax on regulated investment companies, and on mutual savings banks, and, to some extent, of the tax on life insurance companies. Sections 561–565 contain special rules for determining the amount of the deduction for dividends paid in such cases.

From 1936 through 1939 we had an undistributed profits tax on all corporations—in addition to the regular income tax. This caused much controversy at the time, and the bad feeling it engendered has not fully subsided. The cases under it are now ancient history. But its impact on the development of our tax law is not entirely gone.

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1 See Alpert, "The Effect of Long-term Gains on the Personal Holding Company Tax," 33 Taxes 840 (1955); Levine, "The Gross Income in the Personal Holding Company," 9 Tax L.Rev. 453 (1954); Roberts, Rubin and Silverman, "'Rent' as a Factor in Imposing Personal Holding Company Penalties," 1 J. of Taxation 10 (1954).

2 See, generally, Dolan, "How to Avoid Personal Holding Company Pitfalls," 91 J. of Accountancy 704 (1951); Hoskins, "Personal Holding Company Surtax," 37 Geo.L.J. 370 (1949); Rudick, "Section 102 and Personal Holding Company Provisions of the Internal Revenue Code," 49 Yale L.J. 171 (1939); Halperin, "Personal Holding Company Income," 23 Taxes 532 (1945); Winsten, "Personal Holding Company Income," 23 Taxes 701 (1945); Silverson, "The 'Dividends Paid' Credit and Personal Holding Companies," 19 Taxes 525 (1941).

See also Harrar, "The Personal Holding Company in Consolidated Returns," 9 Tax L.Rev. 53 (1953). This matter is now covered by sec. 542(b) of the 1954 Code.

Problem

Would it be feasible or desirable to tax corporations *only* on their undistributed profits, allowing them to deduct dividends paid as well as interest?[3] Thus, if a corporation paid out all of its earnings as dividends it would pay no income tax. What basis is there for objection to such a proposal? Would it not be better than the deduction and credit for dividends received which was introduced by the 1954 Code?

Double Taxation of Corporate Income

Except for the deduction and credit for dividends received, which were introduced by the 1954 Code, there is, under our present taxing scheme, at least a formal double tax on all income derived through the ordinary corporation. The income is first taxed to the corporation as it is earned, and is then taxed to the shareholders when it is distributed as dividends. How far there is actually a double tax depends on how far the corporate tax is "passed on" to others, such as employees (through reduced wages), and customers (through higher prices).

There has been a great deal of discussion about this problem, and the provisions for deduction and credit of dividends in the 1954 Code are an attempt to deal with it. For earlier discussions of the matter, see Crum, "The Taxation of Stockholders," 64 Q.J. Econ. 15 (1950); Raymond, "A Suggestion for the Double Taxation Problem," 24 Taxes 956 (1946); Elkin, "Double Taxation of Dividends," 32 Bull.Nat.Tax Assn. 129 (1947); and an important study by the Division of Tax Research of the Treasury Department on the taxation of corporate dividends, published in 1946.

For a recent economic discussion of the incidence of the corporate income tax, see Marberry, "On the Burden of the Corporate Income Tax," 11 Nat'l Tax J. 335 (1958).

Intercorporate Dividends

The double tax on income derived through corporations would be a triple or quadruple tax, or more, if dividends received by corporations were taxed in full. In the beginning, our income tax law dealt with this problem by allowing corporations to deduct the full amount of dividends received. This continued through the year 1934. See sec. 23(p) of the Revenue Act of 1934. By sec. 102(h) of the Revenue Act of 1935, this provision was amended so as to make dividends deductible only to the extent of 90 per cent. In 1936, the deduction was reduced to 85 per cent of dividends received from domestic corporations (see secs. 13(a)(2) and 26(b) of the Revenue Act of 1936), where it has re-

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[3] See Vickrey, "A Reasonable Undistributed Profits Tax," 23 Taxes 122 (1945).

mained. It is now allowed as a deduction to corporations by sec. 243(a) of the 1954 Code. It is 100 per cent in the case of dividends received by small business investment companies. See sec. 243(b).

What is the purpose of the limitation on the exemption? For discussion, see Miller, "Taxation of Intercorporate Dividends," 17 Taxes 150 (1939), Proc.Nat.Tax Ass'n 430 (1938); Miller, "The Taxation of Intercompany Income," 7 Law and Contemporary Problems 301 (1940). The tax on intercorporate dividends can be avoided where consolidated returns are available, but this involves an increase of 2 per cent in the over-all tax rate. Sec. 1503(a).

Note the provision of sec. 246(c) of the Code, which was added by the Technical Amendments Act of 1958. This is designed to deal with this problem: A corporation buys stock just before the dividend date. Then it receives the dividend. Let us say the amount is $100.00. Then (but for this new provision) the intercorporate dividend deduction would be 85%, and $15.00 would remain taxable. Immediately after the dividend is received, or after the record date, the corporation sells the shares. They might sell for $100.00 less than the purchase price because of the dividend payment. This would be a short term loss, and would be deductible in full against capital gains. The 1958 amendment disallows the dividend received deduction in such cases.

It should be noted again here (see page 674(F), above) that in the case of a dividend received by a corporation in property, the amount of the dividend is no more than the adjusted basis of the property to the distributor. Sec. 301(b)(1)(B). Thus the deduction for dividends received is limited to 85% of the adjusted basis, and the property takes the distributor's basis as its basis in the hands of the recipient corporation. Sec. 301(d)(2)(B).

This arrangement had its origin (in somewhat different form) in an amendment which was made to sec. 26(b) of the 1939 Code in 1951. Prior to this amendment, it had been possible to gain a tax advantage in certain cases by paying dividends in property. A subsidiary might have property which was fully depreciated, so that its basis was zero, but which nevertheless had a substantial market value. As long as it was held by the subsidiary, no depreciation deduction could be obtained, because the basis was exhausted. If the property was distributed to the parent as a dividend, the parent would pay tax on only 15% of its then fair market value (because of the previously unqualified 85% divi-

dends received credit). But the property would then take as its basis in the parent's hands the then full fair market value. Thus the parent could take depreciation deductions, and would have a substantial basis to take into account in the event of a sale.

Under the 1951 amendment, this problem was dealt with not by affecting the amount of the dividend, but by limiting the credit for dividends received to 85% of the adjusted basis of the property in the hands of the distributing corporation. Thus, if that basis is zero, the receiving corporation included in gross income the entire fair market value of the property, but was entitled to no credit for dividends received. Since it included the fair market value of the property as income, it was then entirely appropriate for it to take the fair market value of the property as its basis.

In the 1954 Code, the approach is different, as indicated above. The amount of the dividend is limited to the adjusted basis of the property, if that is less than the fair market value. This in turn limits the deduction for dividends received, and also the basis of the property in the hands of the recipient. In effect, there is a 100% intercorporate dividend credit for unrealized appreciation of property, with no change in basis as the property is passed from corporation to corporate shareholder.

Cooperative Organizations

Secs. 521 and 522 of the 1954 Code

Farmers' cooperative organizations are exempted from tax under sec. 521, but are subjected to tax by sec. 522. See also sec. 501(c)(16). Under sec. 522 such farmers' cooperatives are subjected to the ordinary corporate taxes, and to those on capital gain, but they are allowed to deduct the amount of their dividends and patronage refunds. Thus, the cooperatives themselves are, in effect, subjected to tax only on their undistributed income.

However, in actual operation, the farmers' cooperatives are enabled to keep their earnings without tax. This is because sec. 522(b) allows the cooperative to deduct not only cash distributions to its members, but also allocations made in certificates of indebtedness distributed to their members. See also secs. 1.522–1 through 1.522–3 of the Income Tax Regulations. But in the hands of the members, these certificates, often without any definite payment date, are of indefinite value. The Treasury tried earnestly to secure decisions that the receipt of the certificates was taxable at the fair market value of the certificates, but after several defeats in court, has now amended its regulations to provide that no income is realized by the member on the receipt

of a certificate which has no fair market value at that time. See sec. 1.61–5 of the Income Tax Regulations, as amended by Treasury Decision 6428, filed December 2, 1959.

Thus, in practical effect, farmers' cooperatives can deduct their earnings, keep them tax-free for expansion of the business, and distribute certificates to their members based on these earnings, which, however, are not taxable to the members. This is a substantial discrimination in favor of farmers' cooperatives. Efforts by the Treasury to obtain amendment of the statute have so far not been successful.[1]

Patronage Refunds

There are many cooperatives which are not within the exemption provided by secs. 501 or 521. These include the ordinary consumers' cooperative. In the case of non-exempt cooperatives, may they deduct their so-called "patronage refunds" (made to their members in proportion to their purchases) in computing their taxable net income? Are these deductible as a business expense, or as a reduction of gross sales, or are they non-deductible on the ground that they are dividends? [2] Does it make any difference that some of the earnings of the cooperative are derived from business done with non-members? Must the obligation to pay a patronage refund be fixed in advance? Is there any reason why any business corporation cannot make refunds to its customers in proportion to their purchases, and deduct the amount as a business expense? If so, is there any basis for the complaint that taxable cooperatives operate under an unfair tax advantage? [3]

In *Uniform Printing & Supply Co. v. Commissioner,* 88 F.2d 75 (C.C.A.7th, 1937), noted in 37 Col.L.Rev. 872 (1937), and 50 Harv.L.Rev. 1321 (1937), the question arose with respect to a corporation organized by 250 insurance companies to do their printing. The bylaws provided that no dividends should be paid and that any surplus earnings should be returned to the stock-

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1 See Ravenscroft, "The Proposed Limitation on the Patronage Dividend Deduction," 12 Tax L.Rev. 151 (1957).

2 See Magill, "The Exemption of Cooperatives from Income Taxation," 11 Tax Executive 297 (1959); Jensen, "The Federal Income Tax Status of Non-exempt Cooperatives," 6 Utah L.Rev. 23 (1958); Asbill, "Cooperatives: Tax Treatment of Patronage Refunds," 42 Va.L.Rev. 1087 (1956); Jacobs, "Cooperatives and the Income Tax Law," 31 Taxes 49 (1953); Magill and Merrill, "The Taxable Income of Cooperatives," 49 Mich.L.Rev. 167 (1950); Morgan, "Patronage Dividends and Their Exclusion from Income," 28 Taxes 358 (1950); Packel, "Cooperatives and the Income Tax," 90 U. of Pa.L.Rev. 137 (1941); O'Meara, "The Federal Income Tax in Relation to Consumer Cooperatives," 36 Ill.L.Rev. 60 (1941).

3 See Bradley, "Taxation of Cooperatives," 25 Harv.Bus.Rev. 576 (1947); The Competition of Cooperatives with Other Forms of Business Enterprise, First Interim Report from the Committee on Small Business, House of Representatives (1946).

holders in proportion to the business done for them. In 1930, the corporation distributed the excess receipts in accordance with the by-laws. It treated this amount as "non-taxable income." The Commissioner ruled that the payment was a dividend and not deductible. The court held that the payments were not dividends, but were rebates or reductions of prices charged for services rendered, and were deductible.

HISTORICAL NOTES

CAPITAL STOCK TAX AND (DECLARED VALUE) EXCESS PROFITS TAX

In 1916, Congress imposed a Capital Stock Tax. This was imposed on every corporation "with respect to the carrying on or doing business by such corporation" at the rate of fifty cents for each $1,000 of the fair value of its capital stock and surplus. This tax remained in effect without substantial change until 1926.

In 1933, by sec. 215 of the National Industrial Recovery Act, Congress again imposed a Capital Stock Tax. This tax was at a rate of $1.00 for each $1,000 of the "adjusted declared value" of the corporation's capital stock. The corporation was free to declare any value it desired. The check on the figure it chose was provided by another tax enacted at the same time which was then called the Excess Profits Tax. This was a tax at the rate of 5% of the corporation's net income which was in excess of 12½% of the adjusted declared value of the stock. The rates of these taxes were changed from time to time, and the name of the excess profits tax was changed in 1940 to the Declared Value Excess Profits Tax. They were at all times unpopular. They were not productive of much revenue. Finally, both taxes were repealed by secs. 201 and 202 of the Revenue Act of 1945.[1]

The Capital Stock Tax (and therefore the Declared Value Excess Profits Tax) only applied to corporations which were "doing business." A number of cases involved the question whether a mere holding company came within this provision. See *Zonne v. Minneapolis Syndicate,* 220 U.S. 187 (1911); *Von Baumbach v. Sargent Land Co.,* 242 U.S. 503 (1917). A corporation which was engaged in liquidating property was subject to the tax. *Magruder v. Washington, Baltimore & Annapolis Realty Corp.,* 316 U.S. 69 (1942). In *Haggar Co. v. Helvering,* 308 U.S. 389 (1940), it was held that where a declaration of capital stock value had been made, it could be amended by the taxpayer by

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[1] See Fox, "The Federal Capital Stock Tax," 24 Bull.Nat.Tax Assn. 136 (1939); Margulies, "Pitfalls of the Capital Stock Tax," 61 N.J.L.J. 253 (1938); "Federal Excess Profits and Capital Stock Tax," 86 U. of Pa.L.Rev. 88 (1937).

filing an amended return at any time before the due date of the original return. Thereafter the declaration could not be amended, by the express terms of the statute. This led to considerable hardship where an error was made in the original return, which was not discovered until too late for an amendment. It was held that no relief could be granted in such a case. *Scaife Co. v. Commissioner,* 314 U.S. 459 (1941); *Helvering v. Lerner Stores Corp.,* 314 U.S. 463 (1941). Relief was granted in some such cases by special act of Congress. See Act of July 6, 1937, c. 440, 50 Stat. 1014.

EXCESS PROFITS TAX

The origin of the first excess profits tax may be found in the munitions tax which was imposed by Title III of the Revenue Act of 1916. The Act of March 3, 1917, imposed an excess profits tax, and this was superseded by Title II of the Act of October 3, 1917. The tax found its greatest development in Title III of the Revenue Act of 1918. This imposed a tax on corporations for the year 1918, in addition to other income taxes, at the rate of 30% of the excess profits up to 20% of the invested capital, and 65% of the profits which were in excess of 20% of the invested capital, with a further bracket going up to 80% in certain cases. This tax continued in effect, with some modifications, through the year 1921.

This law allowed an excess profits credit (the amount of income not subject to the excess profits tax) of $3,000 plus 8% of the corporation's "invested capital." Invested capital was defined as cash and tangible property paid in for shares, plus surplus and undivided profits, and a limited allowance for intangible property paid in for shares. The law specifically provided that invested capital did not include borrowed capital. The task of determining invested capital of business corporations was an enormous one, and much of the delay in adjusting tax returns during the early twenties was due to it.[1]

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[1] In recommending the repeal of the tax in 1921, the Senate Finance Committee said (Senate Report No. 275, 67th Congress, 1st Session, p. 4): "Whatever may be its theoretical merits, in practice it exempts the overcapitalized corporation, falls more heavily on corporations of small or moderate size than on the larger corporations, penalizes business conservatism, and places on the Bureau of Internal Revenue tasks which are beyond its strength." An extreme case was referred to in 3 Report of the Joint Committee on Internal Revenue Taxation (1928) 21: "The proportions which a single case may assume are brought out by the case of a certain large corporation, where the assessment letter, merely showing the mathematical adjustments, covered 2,267 pages with 317 pages of exhibits." See also Blakey, The Federal Income Tax 190–198, 530–535 (1940).

An important feature of the Excess Profits Tax during the first World War was the provision of secs. 327 and 328 of the Revenue Act of 1918, under which the Commissioner was empowered to adjust the tax if he found that the tax actually imposed by the statute "would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship." This was known as the "special assessment" provision. It was upheld, and the Commissioner's decision under it was held not subject to review by the courts in *Williamsport Wire Rope Co. v. United States,* 277 U.S. 551 (1928).

A comprehensive survey of the general problem of excess profits taxation may be found in Shoup, "Taxation of Excess Profits," 55 Pol.Sci.Q. 535 (1941). See also Shultz, "Economic Effects of a Wartime Excess Profits Tax," 21 Taxes 478 (1943).

Would an excess profits tax on individual incomes be feasible? Or desirable? See Meyers, "Excess Profits Tax on Individuals," 19 Taxes 710 (1941); Tucker, "Excess Income Tax as a Source of Federal Revenue," 20 Taxes 515 (1942). An excess profits tax was imposed on partnerships and individuals in 1917. It was not continued in 1918.

Excess Profits Tax of World War II. Another excess profits tax was initiated by the Second Revenue Act of 1940. It was extensively amended by the Excess Profits Tax Amendments of 1941, and was frequently amended thereafter. It was applicable for the six years beginning with 1940 and through 1945. It was repealed by the Revenue Act of 1945.

This tax was at a rate which went as high at 95%. It was imposed by sec. 710 of the 1939 Code on the "adjusted excess profits net income." This term was defined by sec. 710(b) as the "excess profits net income" less the sum of (1) a specific exemption, which in the later years was $10,000, (2) the excess profits credit, and (3) the unused excess profits credit adjustment. The latter term was defined by sec. 710(c) to allow carry-back and carry-over for two-year periods each way of unused excess profits credit.

In determining the excess profits credit, the taxpayer was given the option of using either one of two methods. It could take a percentage of the invested capital (8% of the first $5,000,000, and a smaller percentage of larger amounts), or it could take 95% of the average base period net income. The average base period net income was defined in sec. 713, as the average net income for the four pre-war years 1936 through 1939, with

adjustments as specified in that section. Where a taxpayer had high pre-war earnings, it would ordinarily elect to determine its excess profits taxes on the average income basis. If its pre-war earnings had been poor, however, it might obtain a higher excess profits credit by using the invested capital basis. In the early years of the tax the Treasury sought several times to eliminate the average income basis, but it was never able to persuade Congress to do so.

In the determination of excess profits net income, a number of adjustments were provided in sec. 711 of the 1939 Code. Many of the questions under the tax arose in connection with making these adjustments. Where the taxpayer elected the invested capital method, the definition of invested capital was provided by secs. 715 through 720. Invested capital consisted of equity invested capital and borrowed invested capital. By sec. 719, only 50% of borrowed capital was allowed to be counted. Equity invested capital was defined by sec. 718. It included all money and property paid in for stock, regardless of whether the property was tangible or intangible. It also included accumulated earnings and profits at the beginning of the taxable year.

A number of relief provisions were included in the Code. One of these was in sec. 721, which provided for adjustments on account of abnormalities in income during the taxable year. Another was sec. 722, which provided for relief from excess profits tax where the taxpayer could show that the tax computed under the statute was "excessive and discriminatory" and could show further that it came within the conditions for relief specified in that section. Section 722 was a highly involved provision which is still with us. The Treasury issued a Bulletin on Section 722 of the Internal Revenue Code (1944), which discussed this provision in considerable detail, and furnished a text which may be cited by a revenue agent for the disallowance of almost any claim. The statute expressly provided that determinations by the Treasury under secs. 711, 721, and 722, shall be reviewed only by the Tax Court. There is no appeal from the Tax Court's decisions on these questions. Decisions under sec. 722 (and some parts of sec. 721) are reviewed by a special division of the Tax Court, and are not subject to further review by the Tax Court itself.

Although the excess profits tax law was in force more than six years, and is now repealed, there is still relatively little case law about it. The statute was one of extreme complexity. The Treasury issued extensive and equally difficult regulations (Regulations 112) under it. The details of the law can be mastered only by a considerable amount of application. After the first World War, a large number of excess profits tax cases remained in litigation for ten or twelve years, and some cases were not

finally disposed of for more than twenty-five years. It seems almost certain that excess profits cases of the more recent vintage will be with us for a long time to come.

An excess profits tax was again imposed (effective with taxable years ending after June 30, 1950) by the Excess Profits Tax Act of 1950, approved January 3, 1951. This statute was based upon the excess profits tax provisions which were in effect during World War II. It follows the same general pattern, but there are many differences of detail, most of which made the new statute even more complicated than its predecessors.

This tax was found in secs. 430 through 474 of the 1939 Code. It expired with the close of 1953.[1]

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1 See Bierman, "Excess Profits Tax Termination," 9 Tax L.Rev. 25 (1953). For treatment of questions under the excess profits tax, see Vernon and Malloy, "Borrowed Capital for Excess Profits Tax Purposes," 6 Tax L.Rev. 379 (1951); Rudick, "Tax Orientation under EPT III," 6 Tax L.Rev. 337 (1951); Keith, "The Excess Profits Tax Act of 1950," 4 Nat.Tax J. 193 (1951); Smith, "Role of Invested Capital Base in Excess Profits Taxation," 4 Nat. Tax J. 208 (1951); Oakes, "General Relief under the Excess Profits Tax," 4 Nat.Tax J. 219 (1951); Oakes, "The Revenue Act of 1951: Excess Profits Tax Amendments," 5 Nat.Tax J. 53 (1951); Eldridge, "Extractive Industries and the Excess Profits Tax," 4 Nat.Tax J. 315 (1951); Alexander, "General Relief Provisions of the Excess Profits Tax Act of 1950," 60 Yale L.J. 395 (1951); "Relief Provisions of the Excess Profits Tax Act of 1950," 64 Harv.L.Rev. 1143 (1951); Rice, "Corporate Reorganizations, Tax Planning, and the Excess Profits Tax of 1950," 39 Calif.L.Rev. 331 (1951); "Excess Profits, Borrowed Capital and Bonds: Latent Tax Loophole," 61 Yale L.J. 561 (1952); Cork "Corporate Liquidation under the Excess Profits Tax," 13 U. of Pitt.L.Rev. 680 (1952).

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ESTATE AND GIFT TAXES

CHAPTER 11

ESTATE TAX

Secs. 2001–2207 of the 1954 Code

Regulations have been issued with respect to the estate tax under the 1954 Code. They were approved June 16, 1958, and are published in 1958–2 Cum.Bull. 432. They may be found in tax services under section numbers corresponding to the Sections of the Code.

The estate tax is extensively treated in Mertens, Law of Federal Gift and Estate Taxation, 6 vols., 1959; Beveridge, Law of Federal Estate and Gift Taxation, 3 vols. 1959; Stephens and Marr, The Federal Estate and Gift Taxes (1959); ~~Lowndes and~~ Kramer, Federal Estate and Gift Taxes ([redacted]). See also Lowndes, "A Practical Program for Reforming the Federal Estate Tax," 5 Villanova L.Rev. 1 (1959); Eisenstein, "The Rise and Decline of the Estate Tax," 11 Tax L.Rev. 223 (1956); Porterfield "Fed. Est. Tax Procedural Guide," 41 Taxes 421 (196

A. Introduction

The idea of a tax on the transmission of property at death is an appealing one. Taxes of this sort have been in vogue since ancient times, though Pliny the Younger argued that a tax on inheritance "was an 'unnatural' tax, augmenting the grief and sorrow of the bereaved." [1] After the feudal charges of relief and primer seisen had disappeared, we find the first trace of modern death duties in a stamp tax of five shillings imposed by the Stamp Act of 1694 (5 & 6 William and Mary, c. 21, sec. 3) upon the probates of wills and letters of administration. In the United States, a legacy duty was enacted as early as 1797. Act of July 6, 1797, c. 11, 1 Stat. 527, effective July 1, 1798—see Act of December 15, 1797, c. 1, 1 Stat. 536. This was repealed in 1802. Act of April 6, 1802, c. 17, 2 Stat. 148. Not until the Civil War was another federal death tax imposed. This was a tax running up to five per cent (later six per cent) and applying at first to personal property only. Its constitutional validity as an excise

[1] Shultz, Taxation of Inheritance (1926) 6, quoted by Arnold Raum in 48 Yale L.J. 358 (1938).

tax was upheld by the Supreme Court in *Scholey v. Rew,* 23 Wall. 331 (1874). The tax had already been repealed—in 1870.

The Income Tax Act of 1894 (Act of August 27, 1894, c. 349, 28 Stat. 509, 553) contained a suggestive provision under which "property acquired by gift or inheritance" would have been taxed as income.[2] This innovation fell, however, with the rest of the act in the decision in *Pollock v. Farmers' Loan & Trust Co., supra* p. 33. The Spanish War in 1898 brought with it a graduated inheritance tax. This was the tax which was sustained in *Knowlton v. Moore, supra,* p. 40. It was repealed in 1902.

During this time, a system of state inheritance tax laws was slowly growing up. The first of these seems to have been "An Act relating to collateral inheritances," enacted by the legislature of Pennsylvania in 1826. Pa.Laws, 1825–1826, c. 72. This early law shows the continuity of the problems in this field, for it included in its operation transfers "by deed, grant, bargain or sale, made or intended to take effect, in possession or enjoyment after the death of the grantor." By 1916 substantially this same clause had been included in at least forty state death tax statutes. See Brief for the Petitioner, pp. 20–22, in *Hassett v. Welch,* 303 U.S. 303 (1938), No. 375, October Term, 1937. This language was in our estate tax law from the beginning until 1954. It was most recently found in sec. 811(c) of the 1939 Code. It is now gone and its progeny are found in secs. 2036 and 2037 of the 1954 Code.

Practically all of these early state and federal death taxes were "inheritance" taxes, that is, taxes on the right to succeed, rather than "estate" taxes, which are imposed on the decedent's right to transmit his property. There are certain merits in each kind of tax. A succession tax may be graduated according to the amount received, and according to the relationship of the recipient to the deceased. On the other hand, a succession tax is exceedingly difficult to administer where the will provides contingent future interests, so that the person who will take and the amount he will receive may remain uncertain for many years after the decedent's death. See, *e. g., Salomon v. State Tax Commission,* 278 U.S. 484 (1929), involving the effort of New York to solve this problem. This difficulty is obviated where the tax is imposed simply on the decedent's estate, payable shortly after death by his executor. The federal death tax which has been in

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[2] For an economist's view of the merits of this plan, see Simons, Personal Income Taxation c. VI (1938). It seems not impossible (though there are many difficulties in the way) that future federal tax development may take the form of combining the present income, estate, and gift taxes into one comprehensive tax on all receipts. Cf. Rudick, "What Alternative to the Estate and Gift Taxes?" 38 Calif.L.Rev. 150 (1949).

force since September 8, 1916, is an *estate* tax.[3] There have, however, been numerous efforts to convert the federal tax into an inheritance tax. The most recent of these was in 1935, when the House of Representatives passed such a tax to supersede the estate tax. See House Report No. 1681, 74th Congress, 1st Session, pp. 8–10. The change was not, however, accepted by the Senate (see Senate Report No. 1240, 74th Congress, 1st Session, pp. 8–10); and it went out in conference. House Report No. 1885, 74th Congress, 1st Session, p. 10. The change may yet come, but it seems unlikely. New York, and some other States, which once had an inheritance tax, have discarded it and now have an estate tax instead.

The current federal estate tax has had a continuous history from September 8, 1916, when the Revenue Act of 1916 became effective. Section 201 of that Act imposed a tax running from one per cent on the first fifty thousand dollars up to ten per cent of the excess of the value of an estate over five million dollars. An exemption of fifty thousand dollars was allowed. The rates were considerably increased by section 401 of the Revenue Act of 1918; the maximum under that Act was twenty-five per cent on estates in excess of ten million dollars. There was a further increase in 1924, but in 1926 substantially the 1918 rates were restored, and the exemption was raised to $100,000. The Revenue Act of 1924 was the first to provide a credit against the federal tax on account of death taxes paid to the States. This credit was originally limited to twenty-five per cent of the federal tax, but in the Revenue Act of 1926, this was raised to eighty per cent. Thus, the federal estate tax became chiefly effective as an inducement to the States to adopt systems of death taxes. See *Florida v. Mellon,* cited *infra* p. 949. Indeed, many of the States arranged their inheritance or estate tax laws so that they would produce in a particular case exactly eighty per cent of the federal tax.

Beginning with the Revenue Act of 1932, Congress sought to make the estate tax really productive of revenue to the federal Government. Section 401 of the Revenue Act of 1932 imposed an "Additional Estate Tax" all of which went to the federal Government without any credit for State taxes paid. The rates of the additional estate tax were raised in 1934 and again in 1935, 1940, and 1941, so that the total estate tax and additional estate tax reached a rate of seventy-seven per cent of estates in excess of ten million dollars. In the Internal Revenue Code of 1954 these

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[3] It would seem that there should not be, and that there are not now, any constitutional differences between the power to impose a succession tax and the power to impose an estate tax, although at one time this was a burning issue. See, e.g., the dissenting opinion of Mr. Justice Roberts in Coolidge v. Long, 282 U.S. 582 (1931). Cf. Stebbins v. Riley, 268 U.S. 137 (1925).

two taxes have been combined into a single rate schedule in sec. 2001. See also sec. 2011(d).

Just before 1916, the total amount of revenue produced by the State inheritance tax laws was about $27,000,000 per year. In the years 1958 and 1959 the federal collections of estate and gift taxes averaged about $1,400,000,000 annually. This would mean that the total State and federal death taxes would now come to a sum close to two billion dollars per year.

The economic effect of this increase in death taxation has been considerable. It has not been unintended. In 1924, Representative John N. Garner, speaking in the House of Representatives, said: "One purpose of an inheritance or an estate tax is to encourage the distribution of large estates." Congressional Record, 68th Congress, First Session, Part 3, p. 3122. At the time that the additional estate taxes were under consideration in 1932, Congressman La Guardia spoke in the following terms: "The increase in the inheritance tax is in keeping . . . with the policy not only to raise needed revenue but to establish social legislation which will eventually prevent the concentration of the wealth of the nation into the hands of a few families." Congressional Record, 72d Congress, First Session, Part 6, p. 6678. The social consequences of the present taxes are discussed in popular terms in Myers, The Ending of Hereditary American Fortunes (1939). See also Hall, "Incidence of Death Duties," 30 Am.Econ.Rev. 46 (1940); Wedgwood, The Economics of Inheritance (1929).

Constitutionality. The constitutionality of the modern federal estate tax was sustained in *New York Trust Co. v. Eisner,* 256 U. S. 345 (1921), against the argument that it was a direct tax, and thus invalid since it was not apportioned as the Constitution requires such taxes to be. It was with respect to this contention that Mr. Justice Holmes said, after reviewing earlier cases: "Upon this point a page of history is worth a volume of logic." The general question is discussed in Lowndes, "The Constitutionality of the Federal Estate Tax," 20 Va.L.Rev. 141 (1933). See also Lowndes, "Current Constitutional Problems in Federal Taxation," 4 Vanderbilt L.Rev. 469 (1951).

Notes

(A) In *United States Trust Co. v. Helvering,* 307 U.S. 57 (1939), the Court held that proceeds of war risk insurance were subject to estate tax despite the provisions of section 22 of the World War Veterans' Act of 1924 that such "insurance . . . shall be exempt from all taxation." The Court said (p. 60):

"An estate tax is not levied upon the property of which an estate is composed. It is an excise imposed upon the transfer of or

shifting in relationships to property at death. The tax here is no less an estate tax because the proceeds of the policy were paid by the Government directly to the beneficiary; the taxing power was nevertheless exercised upon 'the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, or having it pass to another.' (*Chase National Bank v. United States,* 278 U.S. 327, 337.) In an analogous situation, federal bonds exempt by statute from all taxation have been held subject to a federal inheritance tax. (*Murdock v. Ward,* 178 U.S. 139.) And State inheritance taxes can be measured by the value of federal bonds exempted by statute from State taxation in any form. (*Plummer v. Coler,* 178 U.S. 115.) Similarly, the statutory immunity of War Risk Insurance from taxation does not include an immunity from excise upon the occasion of shifts of economic interests brought about by the death of an insured." [1]

The Treasury has made a similar ruling with respect to National Service Life Insurance. See letter from D. S. Bliss, Deputy Commissioner, October 21, 1943, in par. 23,913 of the Prentice-Hall Federal Tax Service.

(B) *Retroactivity.* In the earlier days of the estate tax, a great deal of attention was paid to the question of retroactivity, or retroactive application of the taxing statute. In *Shwab v. Doyle,* 258 U.S. 529 (1922), the question involved a gift made in April, 1915, more than a year before the enactment of the Revenue Act of 1916, the first taxing statute. The decedent died September 16, 1916, eight days after the enactment of the statute. The Court held that the statute "should not be construed to apply to transactions completed when the act became a law." A similar result was reached in *Knox v. McElligott,* 258 U.S. 546 (1922), with respect to the inclusion of the entire value of jointly held property where the joint tenancy was created before 1916. As a result of these decisions, and others like them, the general retroactive clause now found in sec. 2044 of the 1954 Code was added to the statute.[2]

In *Nichols v. Coolidge,* 274 U.S. 531 (1927), the Court held that sec. 811(c) could not constitutionally be applied to a transfer made in 1907, with a life estate reserved to the transferor, when the decedent died in 1921.

The general policy against retroactivity has been reflected in the development of the statute. Statutory changes are ordinarily made applicable only with respect to decedents who die after the date of the enactment of the statute, and are often made inapplicable to transfers made before the statute is changed. See secs. 2036(b) and 2038 of the 1954 Code.

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[1] See also Greiner v. Lewellyn, 258 U.S. 384 (1922), upholding the federal estate tax as applied to municipal bonds owned by the decedent; United States Trust Co. v. Commissioner, 307 U.S. 57 (1939); Greene v. United States, 171 F.Supp. 459 (Ct.Cls.1959), cert. den. 360 U.S. 933 (1959).

[2] On retroactivity, generally, see Cahn, "Time, Space, and Estate Tax," 29 Geo.L.J. 677 (1941).

For consideration of current problems in estate tax field, see Zissman, "Problems are in the Estate Tax," 41 Taxes 875 (1963

B. THE GROSS ESTATE

Secs. 2031–2044 of the 1954 Code

1. Property Owned by the Decedent

Sec. 2033 of the 1954 Code

Section 2033 of the Internal Revenue Code of 1954 (formerly found in sec. 811(a) of the 1939 Code, and, before that, in sec. 302(a) of the Revenue Act of 1926) taxes the property owned by the decedent at the time of his death. This might be said to be the layman's concept of the estate tax; and it presents little room for controversy. The chief problems arise under the other provisions defining the gross estate which undertake to reach out and include property in addition to that which was technically owned by the decedent at the moment of his death. But there are some questions under the provision now found in sec. 2033, as illustrated in the following cases.

HELVERING v. SAFE DEPOSIT & TRUST CO.

Supreme Court of the United States, 1942. 316 U.S. 56.

MR. JUSTICE BLACK delivered the opinion of the Court. . . .

Zachary Smith Reynolds, aged 20, died on July 6, 1932. At the time, he was beneficiary of three trusts: one created by his father's will in 1918, one by deed executed by his mother in 1923, and one created by his mother's will in 1924. From his father's trust, the decedent was to receive only a portion of the income prior to his twenty-eighth birthday, at which time, if living he was to become the outright owner of the trust property and all accumulated income. His mother's trusts directed that he enjoy the income for life, subject to certain restrictions before he reached the age of 28. Each of the trusts gave the decedent a general testamentary power of appointment over the trust property; in default of exercise of the power the properties were to go to his descendants, or if he had none, to his brother and sisters and their issue *per stirpes.*

The Commissioner included all the trust property within the decedent's gross estate for the purpose of computing the Federal Estate Tax. The Board of Tax Appeals and the Circuit Court of Appeals, however, held that no part of the trust property should have been included.

I

The case presents two questions, the first of which is whether the decedent at the time of his death had by virtue of his general powers of appointment, even if never exercised, such an interest

in the trust property as to require its inclusion in his gross estate under Section 302(a) of the Revenue Act of 1926, 44 Stat. 9, 70. This section provides:

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

"(a) To the extent of the interest therein of the decedent at the time of his death;"

The government argues that at the time of his death the decedent had an "interest" in the trust properties that should have been included in his gross estate, because he, to the exclusion of all other persons, could enjoy the income from them; would have received the corpus of one trust upon reaching the age of 28; and could alone decide to whom the benefits of all the trusts would pass at his death. These rights, it is said, were attributes of ownership substantially equivalent to a fee simple title, subject only to specified restrictions on alienation and the use of the income. The respondents deny that the rights of the decedent with respect to any of the three trusts were substantially equivalent to ownership in fee, emphasizing the practical importance of the restrictions on alienation and the use of income, and arguing further that the decedent never actually had the capacity to make an effective testamentary disposition of the property because he died before reaching his majority.

We find it unnecessary to decide between these conflicting contentions on the economic equivalence of the decedent's rights and complete ownership.[1] For even if we assume with the government that the restrictions upon the decedent's use and enjoyment of the trust properties may be dismissed as negligible and that he had the capacity to exercise a testamentary power of appointment, the question still remains: Did the decedent have "at the time of his death" such an "interest" as Congress intended to be included in the decedent's gross estate under Section 302(a) of the Revenue Act of 1926? It is not contended that the benefits during life which the trusts provided for the decedent, terminating as they did at his death, made the trust properties part of his gross estate under the statute. And viewing Section 302(a) in its background of legislative, judicial, and administrative history, we cannot reach the conclusion that the words "interest . . . of the decedent at the time of his

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[1] In declining to pass upon this issue, we do not reject the principle we have often recognized that the realities of the taxpayer's economic interest rather than the niceties of the conveyancer's art should determine the power to tax. See Curry v. McCanless, 307 U.S. 357, 371, and cases there cited. Nor do we deny the relevance of this principle as a guide to statutory interpretation where, unlike here, the language of a statute and its statutory history do not afford more specific indications of legislative intent. Helvering v. Clifford, 309 U.S. 331.

death" were intended by Congress to include property subject to a general testamentary power of appointment unexercised by the decedent.

The forerunner of Section 302(a) of the Revenue Act of 1926 was section 202(a) of the Revenue Act of 1916, 39 Stat. 777. In *United States v. Field,* 255 U.S. 257, this Court held that property passing under a general power of appointment *exercised* by a decedent was not such an "interest" of the decedent as the 1916 Act brought within the decedent's gross estate. While the holding was limited to *exercised* powers of appointment, the approach of the Court, the authorities cited, and certain explicit statements in the opinion left little doubt that the Court regarded property subject to *unexercised* general powers of appointment as similarly beyond the scope of the statutory phrase "interest of the decedent."

After the *Field* case, the provision it passed upon was reenacted without change in the Revenue Act of 1921 (Section 402(a), 42 Stat. 278) and in the Revenue Act of 1924 (Section 302(a), 43 Stat. 304). If the implications of the *Field* opinion with respect to unexercised powers had been considered contrary to the intendment of the words "interest of the decedent" it is reasonable to suppose that Congress would have added some clarifying amendment.

When it was held in the *Field* case that property subject to an *exercised* general testamentary power of appointment was not to be included in the decedent's gross estate under the Revenue Act of 1916, this Court referred to an amendment passed in 1919 which specifically declared property passing under an *exercised* general testamentary power to be part of the decedent's gross estate. The passage of this amendment, said the Court, "indicates that Congress was at least doubtful whether the previous act included property passing by appointment." [2] In the face of such doubts, which cannot reasonably be supposed to have been less than doubts with respect to *unexercised* powers, Congress nevertheless specified only that property subject to *exercised* powers should be included. From this deliberate singling out of *exercised* powers alone, without the corroboration of the other matters we have discussed, a Congressional intent to treat *unexercised* powers otherwise can be deduced. . . .[3]

The judgment of the Circuit Court of Appeals is reversed with directions to remand to the Board of Tax Appeals for further proceedings not inconsistent with this opinion.

Reversed.

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2 United States v. Field, supra, 265.

3 A second part of the opinion, dealing with "property passing to the decedent's brothers and sisters as a result of a compromise settlement with other claimants" is omitted. The reversal was on this second point. Ed.

Problems

(A) Compare the decision in *Second National Bank of Danville v. Dallman,* 209 F.2d 321 (C.A.7th, 1954). It there appeared that the decedent's father, who died in 1925, had left a $30,000 insurance policy with the provision that the decedent should receive a yearly payment of 3 per cent of the face amount of the policy for life. The policy also provided that the decedent could name a beneficiary to take the principal amount upon the decedent's death. In default of such a designation, the principal was to be paid to the decedent's "executors, administrators, or assigns." The decedent did not name a beneficiary. She died in 1945. The fund was then paid to her executor who in turn transferred it to a trust established by the residuary clause of the decedent's will.

The court held that nothing was includible in the decedent's gross estate on account of this policy. See "Tax Evasion Through Settlement Options: Another Defeat for Substantial Ownership in Estate Taxation," 64 Yale L.J. 137 (1954).

(B) Suppose a grantor creates a trust irrevocably for his children, but retains such control over it that the income remains taxable to him under the *Clifford* doctrine. When he dies, is the property taxable in his gross estate? Is he "substantially the owner" of the property for estate tax purposes as well as for income tax purposes? Can the *Safe Deposit and Trust* case be distinguished on the ground that in that case the decedent was not the grantor of the trust? See *Estate of Alexander K. Sessoms,* T.C.Memo., Dec. 12, 1949.

(C) A will leaves property with the direction that the income be paid to X, without any disposition of the principal. X dies. Is the property part of his gross estate? See *Sharpe v. Commissioner,* 107 F.2d 13 (C.C.A.3d, 1939).

(D) Property is left to X for life, remainder to Y if he survives X. Y dies while X is still living. Is anything taxable in Y's estate? See *Hamlin v. United States,* 66 Ct.Cl. 501 (1928); *Commissioner v. Rosser,* 64 F.2d 631 (C.C.A.3d, 1933). What would be the result if Y had had a contingent remainder where the contingency was something other than survivorship?

(E) The decedent held title to property for her husband in order to keep it out of the reach of his creditors. Should it be included in her gross estate? *Estate of Giles v. Commissioner,* B.T.A.Memo., May 8, 1939. Would the result be any different if she held it on an oral trust which was unenforceable under the statutes of frauds? See *Chandler v. United States,* 177 F.Supp. 565 (D.N.H.1959), where the decedent held property as trustee of a resulting trust for her son.

(F) The decedent was a member of a law firm. The partnership agreement provided that on the death of a partner his estate should receive his percentage of the net profits of the firm for the period of 18 months following his death, and that "this shall be in full of the retiring or deceasing member's interest in the capital, the assets, the receivables, the possibilities and the good will of the Firm." After the decedent's death, his partners continued the business and paid to his executors 8% (his share) of

the net profits for the 18 months following his death. Is the amount so paid to be included in the decedent's gross estate? Consider the fact that the payment was out of income, and for a period following the decedent's death. See *McClennen v. Commissioner,* 131 F.2d 165 (C.C.A.1st, 1942).[1]

(G) For consideration of a related problem, see Bilder, "Death Benefits Paid under an Express Contract," 34 Taxes 529 (1956).

Proceeds of Wrongful Death Action

Where action is brought under a state wrongful death statute, the proceeds are not includible in the decedent's gross estate. The decedent never had in his lifetime an interest in the right of action or its proceeds. Rev.Rul. 54–19, 1954–1 Cum.Bull. 179. Similarly, awards to dependents under a State workmen's compensation act are not includible in his gross estate. Rev.Rul. 56–637, 1956–2 Cum.Bull. 600. But this rule may not apply to causes of action which arose in favor of the decedent prior to his death, as for bodily injuries, or conscious suffering, and which survive under statutory provisions, in favor of his personal representatives.

RHODES v. COMMISSIONER

Board of Tax Appeals, 1940. 41 B.T.A. 62.[2]

BLACK.[3] The estate tax and the additional estate tax imposed by sections 301(a) of the Revenue Act of 1926 and 401(a) of the Revenue Act of 1932, respectively, are "upon the transfer of the net estate of every decedent . . ." The term "net estate" means the "gross estate" as defined in section 302 of the Revenue Act of 1926 as amended, less the deductions specified in section 303 as amended. See also section 300(b), Revenue Act of 1926. The respondent determined that, under subdivision (a) of section 302 of the Revenue Act of 1926, the value of decedent's gross estate was $289,175.79, $242,500 of which represented the value of 5,000 shares of common stock of the International Shoe Co. Subdivision (a) provides as follows:

"Sec. 302. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

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1 Cf. Willis, "Tax Planning of Payments by the Partnership to a Retiring or Deceased Partner," 30 So.Calif.L.Rev. 501 (1957); "The Death of a Partner and the Federal Income Tax," 50 Col.L.Rev. 658 (1950).

2 This decision was affirmed on appeal. Helvering v. Rhodes' Estate, 117 F.2d 509 (C.C.A.8th, 1941).

3 The findings of fact are omitted.

"(a) To the extent of the interest therein of the decedent at the time of his death; . . ."

What was the decedent's "interest" in the property the value of which the respondent has included in the decedent's gross estate? The respondent contends that the decedent was the sole owner of all the property which she attempted to dispose of in her will, including the shares of International Shoe Co. stock assigned to her by her children on or about July 30, 1925, and that the two decrees of the Circuit Court of St. Louis County, Missouri, referred to in our findings, are not binding upon the Board as requiring a holding contrary to the respondent's determination.

Petitioners contend that the determination of the decedent's "interest" in the property in question is purely one of the determination of property rights, and, as such, is controlled by the two decrees of the local circuit court.

We agree with the petitioners' contention. If the decedent owned only a life estate in the International Shoe Co. stock assigned to her in 1925 by her children, no part of the value of such property so assigned should be included in her gross estate, only her own share of the stock which she inherited from her husband's estate, which was one-fifth, should be included. Article 11 of Regulations 70, 1929 ed. and Regulations 80, 1934 ed., and article 13 of Regulations 80, 1937 ed., all provide: "Nor shall anything be included [in the decedent's gross estate] on account of an interest or an estate limited for the life of the decedent." The determination of whether the decedent owned only a life estate in the property assigned to her in 1925 by her children or whether she owned an absolute interest therein is clearly a determination of property rights, and, as such is controlled by local law. *Poe v. Seaborn,* 282 U.S. 101; *Tyler v. United States,* 281 U.S. 497; *Freuler v. Helvering,* 291 U.S. 35; *Blair v. Commissioner,* 300 U.S. 5; *Sharp v. Commissioner,* 303 U.S. 624, reversing, *per curiam,* 91 F.2d 802; *Susan B. Armstrong,* 38 B.T.A. 658; *Estate of Frederick R. Shepherd,* 39 B.T.A. 38.

The Circuit Court for the County of St. Louis, State of Missouri, Division No. 2, after a full hearing in the matter, decreed on March 21, 1935, that the assignment executed by the children on July 30, 1925, "be and the same is hereby reformed as of the date of its execution to read" that the children "hereby jointly and severally grant, transfer and assign to our said mother, Mamie D. Rhodes, an estate, for her life only, in and to our joint and several interests in said estate of Taylor Rhodes, deceased. . . ." The assignment as reformed also provided that upon the death of Mamie D. Rhodes "that certain life estate which we hereby assign to her shall terminate and our said joint and

several interests shall thereafter be held and owned by us as if this instrument had not been executed."

There is no evidence that this decree was obtained for the purpose of defeating any Federal estate tax; or that it was obtained by collusion. Such evidence as we do have points to the fact that it was a decree rendered after there was a hearing on the merits and was not a mere consent decree. The respondent has placed in evidence before us the testimony of Leona Kemp, who testified at the hearing before the local circuit court held on March 15, 1935. The substance of her testimony was that she was the secretary to W. E. Baird, the attorney who prepared the original assignment; that Baird had since died; that prior to the preparation of the assignment she remembered seeing "Mr and Mrs. Paul Rhodes and Mr. Hugh Rhodes" at Baird's desk, which was adjacent to her own; that she "heard Mr. Paul Rhodes tell Mr. Baird he wanted to have him draw up a document whereby they could give their share of the estate to their mother for the time of her life, and Mr. Baird made a notation on his calendar pad"; that about four or five days later, Baird placed a paper written in long hand on her desk and asked her to copy it; and that the paper thus handed to her was the original assignment. All of the evidence before us, including the recitals in the decree itself, indicates that the decree was rendered after a hearing on the merits and was in every respect regular. It was a decree adjudicating property rights. There is no evidence that it was ever modified or reversed, and, upon the authority of the above cited cases, it must be taken as establishing conclusively that the children assigned to their mother only a life estate in their interest of their father's estate.

Shortly after the reformation decree J. Jackson Rhodes and Hugh D. Rhodes, individually, and as executors and trustees under the will of Mamie D. Rhodes, deceased filed a suit in the Circuit Court of the County of St. Louis, State of Missouri, May term, 1935, against Paul T. Rhodes, individually and as one of the trustees under the will of Mamie D. Rhodes, deceased, and Mary B. Rhodes, praying "for a decree of this court determining the ownership of all of the property held in the name of Mamie D. Rhodes at the time of her death on January 22, 1934, as between the estate of said Mamie D. Rhodes on the one hand and the plaintiffs and defendants herein on the other, and for such other and further orders and decrees as to the court may seem just and proper." The circumstances surrounding this suit are fully set out in our findings and need not be repeated here. Suffice it to say that on June 5, 1935, the court handed down its decree, in which it gave full faith and credit to the decree of the Circuit Court of the County of St. Louis, Division No. 2, heretofore mentioned and discussed.

It is our opinion that the two decrees in evidence before us establish conclusively that the decedent did not own outright any more than one-fifth of the 5,000 shares of common stock of the International Shoe Co. which the respondent has included in her gross estate and we have so found in our findings of fact. Her "interest" in the remaining four-fifths of the 5,000 shares was a life interest, which ceased with her death, and under the above cited provisions of the respondent's regulations it was error for the respondent to include as a part of the decedent's gross estate the value of 4,000 shares, amounting to $194,000. Excluding $194,000 from the net estate as determined by the respondent leaves a net estate (exclusive of the exemptions) of $48,217.74, which is less than the exemption of $100,000 allowed by section 303(a)(4) of the Revenue Act of 1926 and also less than the exemption of $50,000 allowed by section 401(c) of the Revenue Act of 1932. It follows that there is no Federal estate tax due. Even if it should be held that the second court decree rendered by Division No. 3, June 5, 1935, was a consent decree because it followed substantially the lines of a written agreement which had been previously entered into by the parties, nevertheless, the first court decree of Circuit Court No. 2, reforming the original instrument of transfer, was not a consent decree and settled the question as to ownership of the International Shoe Co. common stock and we are bound by it.

The respondent stresses the importance of the fact that the decedent, after the original assignment from her children in 1925, thereafter treated the property as her own. It is true that she so testified in the affidavit referred to in our findings; that she actually sold 3,000 shares of the stock; that she pledged the remaining stock on loans; and that she attempted to dispose of all the stock in her will. As we look at this case, those were the facts for the local circuit court to consider in arriving at its decision in the matter. We may not assume that it did not do so. The decree having been rendered by a court of competent jurisdiction in a suit between adverse parties after a hearing upon the merits, we feel that we are bound by it. Whether the decree ever should have been rendered under the evidence is not a matter for us to decide. The question of property rights there decided is no longer an open question for the Board or the Federal Courts to consider. *Freuler v. Helvering; Blair v. Commissioner; Sharp v. Commissioner,* all *supra.*

The conclusion which we here reach is not contrary to our recent decision in *Estate of Arthur D. Forst,* 40 B.T.A. 875. In that case we held that a decree of the Orphans' Court of Mercer County, New Jersey, approving a certain claim against the estate was not binding upon the Board as to whether the claim was deductible under section 303 of the Revenue Act of 1926, in arriving

at the net estate. That question was altogether different from the one we have here to decide. Congress has established its own criterion as to what claims are deductible. *Cf. Lyeth v. Hoey,* 305 U.S. 188. . . .

Reviewed by the Board.

Decision will be entered for the petitioners.

STERNHAGEN, dissenting: I do not think that this Board is universally bound by a decree of a state court without regard for the circumstances in which it is rendered. The record in this proceeding does not prove that there was a substantial controversy in which the mother or her estate was unsuccessful in establishing that when she died she owned the International shares and in which the children established against opposition that she had but a life estate. On the contrary it proves that the state court decree was the sanction of a mutually satisfactory agreement in which no one—the administrator *ad litem,* the creditors, the heirs and legatees or anyone else—was adversely interested. Whether that was an arrangement deliberately aimed at the Federal Government's tax interest in the decedent's estate, it is not possible to say; but that still leaves it less than an adversary proceeding resulting in a judicial decree immune to Federal question. . . .[3]

Problems

(A) But compare *M. T. Straight Trust,* 24 T.C. 69 (1955), where the full Tax Court declined to give retroactive effect to a state court reformation decree establishing three separate trusts where there had been one before. See also *First Nat. Bank of Montgomery v. United States,* 176 F.Supp. 768 (S.D.Ala.1959), where, on facts substantially identical to those in the *Rhodes* case, the court refused to accept the state court decree as binding.

(B) Prior to the decedent's death, he had created a trust. Thereafter he bought certain securities. His executors claimed that these were bought for the trust, and were not part of his estate. The question was presented to the appropriate state court which determined that the securities belonged to the trust. The Commissioner determined a deficiency by including the securities as a part of the decedent's estate. The Board of Tax Appeals examined the evidence, and found as a fact that the decedent had not made an effective gift to the trust. This decision was affirmed by the Circuit Court of Appeals. *Sharp v. Commissioner,* 91 F.2d 802 (C.C.A.3d, 1937). But the Supreme Court summarily reversed this decision. 303 U.S. 624 (1938).

Compare *Brainard v. Commissioner,* 91 F.2d 880 (C.C.A.7th, 1937), where the decision in the state court was obtained after the federal tax question had been argued before the Circuit Court of Appeals. That court refused to follow the state court's deci-

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[3] The dissenting opinion of Opper, in which Hill and Disney concurred, is omitted.

sion. The Supreme Court granted certiorari. The case (302 U.S. 682 (1938)) was argued before the Supreme Court on the same day as the *Sharp* case. But a few days following the argument, at which there was some criticism from the Court, the case was dismissed "on motion of counsel for the petitioner."

(C) A dividend is declared prior to the decedent's death, but is payable to stockholders of record on a date following his death. Should it be included in the decedent's gross estate? See Paul, Federal Estate and Gift Taxation § 4.07 (1942); Rev.Rul. 54–399, 1954–2 Cum.Bull. 279. *Cf. Estate of Putnam v. Commissioner*, 324 U.S. 393 (1945), involving the income tax on such a dividend.[4]

FAIR v. COMMISSIONER

United States Circuit Court of Appeals, Third Circuit, 1937. 91 F.2d 218.

THOMPSON, CIRCUIT JUDGE. This is a petition for review of a decision of the Board of Tax Appeals. The petitioner is the executrix of the estate of William B. Fair, deceased. The decedent, a citizen of the State of New Jersey, died July 12, 1932. At the time of his death he was the owner of three hypotecas upon lands in Cuba. The Commissioner included the value of those hypotecas in the decedent's gross estate and assessed a deficiency. The applicable statute is section 302(a) of the Revenue Act of 1926 (44 Stat. 70), which reads:

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

"(a) To the extent of the interest therein of the decedent at the time of his death."

Had this section alone been presented to us for construction, it would appear that the value of the hypotecas was properly included in the decedent's gross estate. The Attorney General, however, in an opinion dated May 14, 1918 (31 Op.Attys.Gen. 287), said, concerning a substantially similar provision of the Revenue Act of 1916: "Real estate as such located outside of the United States, belonging to a decedent resident within the United States should not be included in determining the value of the gross estate of such decedent for the purposes of the tax imposed by Title II of the revenue act of September 8, 1916 (39 Stat. 777)." The Treasury Department accepted this view and incorporated the ruling in T.D. 3735 [2735], 20 Treasury Decisions 435: "The value of real estate, belonging to a decedent resident within the United States at the time of his death, located outside of the United States, meaning thereby the States, Terri-

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4 See Lowndes and Kramer, Federal Estate and Gift Taxes (1956) 466–468; Lowndes and Kramer, "The Accrual of Corporate Dividends under the Federal Estate Tax," 16 U. of Pittsburgh L.Rev. (1954).

tories of Alaska and Hawaii, and the District of Columbia, should not be included in determining the value of the gross estate of such decedent for the purposes of the tax imposed by Title II of the revenue act of September 8, 1916." The same limiting thought was incorporated in the subsequent taxing act of 1934, where section 404 specifically excepts real property situated outside the United States from inclusion in a decedent's gross estate.

The "hypotecas" in question are, describing them rather freely, mortgages without accompanying bond and without a personal debt obligation on the part of the mortgagor. They are classified by Cuban law as "immovables," which term is substantially equivalent to our term "real property." As real property situated outside the United States the value of the hypotecas should have been excluded from the decedent's gross estate and exempted from the transfer inheritance tax.

The decision of the Board of Tax Appeals is reversed.

Notes and Problems

(A) As indicated at the close of the opinion, the statute now provides for the taxation of all property "except real property situated outside of the United States." For the present provisions see secs. 2031, 2033–2038, and 2040–2041 of the 1954 Code.

The meaning of this phrase is considered in Paul, Federal Estate and Gift Taxation § 2.10 (1942). See also Lowndes and Kramer, Federal Estate and Gift Taxes (1956) 543; "Death Taxes and Conflicting Classifications of Interests in Land," 46 Yale L.J. 687 (1937); Drachsler, "Alien Law in Federal Taxation: Characterization of Alien Juristic Concepts," 33 Tulane L.Rev. 751 (1959); Russell, in 38 Taxes 182 (1960).

See *Estate of de Perigny,* 9 T.C. 782 (1947), holding that a 99 year lease, renewable for 999 years, on land in Kenya, is "real property situated outside of the United States."

(B) Suppose a taxpayer bought land abroad for the purpose of avoiding the estate tax on his death. *Cf. Pearson v. McGraw,* 308 U.S. 313 (1939), noted in 34 Ill.L.Rev. 607 (1940). See also *Van Dyke v. Tax Commission,* 235 Wis. 128, 292 N.W. 313 (1940), affirmed *per curiam,* 311 U.S. 605, (1940), where a person domiciled in Wisconsin made a gift in Illinois of 270,000 silver dollars (weighing about seven and one-half tons) in an unsuccessful effort to escape the Wisconsin gift tax.

(C) The decedent, a citizen and resident of New York, died while on a visit to England. His estate included tangible personal property in England. English death duties in the amount of $133,000 were paid with respect to this property. Is the property subject to federal estate tax? Should any allowance be made for the English duties? See *Guaranty Trust Co. v. Commissioner,* 79 F.2d 245 (C.C.A.2d, 1935), noted in 49 Harv.L. Rev. 493 (1936); 34 Mich.L.Rev. 893 (1936); 20 Minn.L.Rev. 571 (1936).

This matter is now affected by a treaty between the United States and Great Britain, eliminating double estate taxation. See pp. 16–17, above, and Kanter, "The United States Estate Tax Treaty Program," 9 Tax L.Rev. 401 (1954). See also the provision for a credit for foreign death taxes in sec. 2014 of the 1954 Code, referred to at p. 955, below.

2. Marital Interests

Sec. 2034 of the 1954 Code

Section 2034, Internal Revenue Code of 1954 (formerly sec. 811(b) of the 1939 Code, and, before that, sec. 302(b) of the Revenue Act of 1926) is essentially a negative provision. It is designed to make clear that nothing is to be excluded from the operation of sec. 2033, or any other provision of the statute, on the ground that it represents an interest which was owned by another as dower, curtesy, or an estate in lieu of dower or curtesy. State inheritance tax laws had often been construed not to apply to such interests. Sometimes this went on the ground that these statutes applied only to property transferred "by will or by the intestate laws," and that this did not cover the interest taken by the surviving spouse. See *Matter of Starbuck,* 137 App.Div. 866, 122 N.Y.Supp. 584 (1910), aff'd without opinion, 201 N.Y. 531, 94 N.E. 1098 (1911); Gleason and Otis Inheritance Taxation 426–431 (4th ed. 1925). Section 2034 and its forerunners, have prevented such a limitation in the construction of the federal law.

The language now included in sec. 2034 first appeared in section 402(b) of the Revenue Act of 1918, and has remained unchanged since that time. Its validity has never been sustained by the Supreme Court, but, despite dialectical arguments to the contrary, there seems now no reason to doubt its constitutionality.

Since the adoption of the marital deduction in 1948 (see p. 861, below), the inclusion of marital interests in the gross estate now has a largely formal significance, as nearly everything included under sec. 2034 will be taken out as a deduction under sec. 2056.

MAYER v. REINECKE

United States Circuit Court of Appeals, Seventh Circuit, 1942. 130 F.2d 350. Certiorari denied 317 U.S. 684 (1942).

KERNER, CIRCUIT JUDGE. We are asked to decide whether an Illinois decedent's gross estate, for federal estate tax purposes, should include the value of the widow's dower and her statutory one-third interest in the personalty.

Plaintiffs as testamentary trustees sued the Collector for the recovery of an alleged overpayment of estate taxes, after the Commissioner had rejected their refund claim premised upon the theory that the value of these marital interests was improperly included in the gross estate. The trial court overruled the Government's demurrer and proceeded to try the case. It entered judgment for the plaintiffs and the Government appeals.

The decedent, Levy Mayer, died testate on August 14, 1922, leaving his widow and two daughters as the principal beneficiaries under the will. October 16, 1922, the will was admitted to probate by the Cook County Probate Court, and letters testamentary were issued to the executors, who duly accounted for all of the estate's property and distributed it according to the will. The Probate Court discharged the executors on December 30, 1925, and, pursuant to that court's order and the provisions of this will, turned over the balance of the estate to the trustees named in the will.

The will provided a substantial legacy for the widow and in addition directed the trustees to pay her a life income from one-half of the residuary estate, and if such trust income was insufficient to meet "her needs and requirements," the will authorized the trustees "in their discretion to use any portion of the principal" of such one-half of the residuary estate for that purpose.

By § 10 of the Dower Act, c. 41, § 10 et seq., these testamentary provisions for the widow barred her dower, unless she renounced in writing their benefits so as to become entitled to dower in the lands and to one-third of the personal estate after the payment of all debts. Moreover, if the renunciation was not within one year after letters testamentary were issued, she would be deemed to have elected to take under the will. The widow made no such renunciation and took under the will.

Initially, we must determine whether this acceptance of the will by the widow or the antecedent execution of the will by the decedent affects the estate tax significance of the value of the marital interests.

It is clear that if either of these events controlled the taxable status of the decedent's property, the entire value of the realty and personalty covered by the will would be includible under § 402(a) and the marital interests would be of no moment.

The taxing statute here involved requires that the taxable status of the decedent's property be determined as of the time of his death. We may not substitute the now certain fact of the widow's acceptance of the will for that which was a mere possibility at the time of the decedent's death; the subsequent renunciation of the marital interests can not affect the value of the estate subject to tax. Nor can the decedent's execution of a will

obviate the problem of whether the value of the marital interest is to be excluded from the gross estate. The widow's dower and statutory share existed to the extent that the decedent could never make an effective testamentary disposition of his estate in derogation of her rights. Therefore, at the decedent's death, it could not be said that all of the property passed under the will, for the wife might not be willing to give up her rights for any testamentary offer of her spouse. This reality existed at the decedent's death and should prevail. Section 10 of the Dower Act does not require the contrary; it merely provides a more simplified procedure of election than the familiar election in equity between the marital rights and the inconsistent provisions of the will, *Davis v. Mather*, 309 Ill. 284, 288, 141 N.E. 209. . . .

In Illinois, it is clear that before the husband's death, the wife "has a mere inchoate right of dower in his lands,—an expectancy,—which does not vest or become property until it is consummated by the death of the husband. . . . Marriage does not in this state vest in the wife the absolute right to dower, but as an incident of the marriage she is given capacity to acquire the right in the event she shall survive her husband," *Virgin v. Virgin,* 189 Ill. 144, 151, 59 N.E. 586, 587, and before the husband's death, the wife can bring no action for it. *Bigoness v. Hibbard,* 267 Ill. 301, 108 N.E. 294, cf. *Bennett v. Bennett,* 318 Ill. 193, 197, 149 N.E. 292. Thus the husband has the right to the full, exclusive possession of his realty and to any income which it might produce. These substantial incidents of ownership exist notwithstanding the wife's inchoate dower. Upon his death, substantial property rights are transferred to the surviving spouse and she becomes entitled to a one-third life estate in the property —an interest that is no longer "an intangible contingent expectancy."

. . . The estate tax is upon a transfer or shifting in the relationship to property occasioned by an individual's death; the particular interest of the decedent which ceased at his death was a legitimate object for the imposition of the excise, cf. *Allen v. Henggeler, supra;* no constitutional right was invaded. Since the tax is imposed upon the transfer of an interest by death, the fact that the property was purchased before the statute was passed is of no constitutional moment. The crucial fact is that the statute was passed before the death of the owner of the land. . . .

The judgment of the District Court is reversed. It is so ordered.

3. Contemplation of Death

Sec. 2035 of the 1954 Code

The phrase "contemplation of death" seems to have made its first appearance in an American death tax statute in 1891. See N.Y.Laws, 1891, c. 215, p. 409. The practical need for some such provision to prevent avoidance of the tax is obvious. Nevertheless, the state courts at first gave the phrase a narrow construction, confining its effect to gifts *causa mortis*. The early decisions under the federal estate tax were generally broader, in language if not in result. But the narrow view was definitely adopted by the Court of Claims in *Wells v. United States,* 69 Ct. Cl. 485, 513, 39 F.2d 998, 1011 (1930), which said that contemplation of death meant "a present apprehension, from some existing bodily or mental condition or impending peril, creating a reasonable fear that death is near at hand, and that such reasonable fear or apprehension must be the direct or animating cause, and the only cause of the transfer."

The Government obtained a review of this case in the Supreme Court. The resulting decision, *United States v. Wells,* 283 U.S. 102 (1931), is the leading case in the Supreme Court on the meaning of this phrase. The Court said (pp. 115–119):

". . . It is recognized that the reference is not to the general expectation of death which all entertain. It must be a particular concern, giving rise to a definite motive. The provision is not confined to gifts *causa mortis,* which are made in anticipation of impending death, are revocable, and are defeated if the donor survives the apprehended peril. *Basket v. Hassell,* 107 U.S. 602, 609, 610. The statutory description embraces gifts *inter vivos,* despite the fact that they are fully executed, are irrevocable and indefeasible. The quality which brings the transfer within the statute is indicated by the context and manifest purpose. Transfers in contemplation of death are included within the same category, for the purpose of taxation, with transfers intended to take effect at or after the death of the transferor. The dominant purpose is to reach substitutes for testamentary dispositions and thus to prevent the evasion of the estate tax. . . .

"As the test, despite varying circumstances, is always to be found in motive, it cannot be said that the determinative motive is lacking merely because of the absence of a consciousness that death is imminent. It is contemplation of death, not necessarily contemplation of imminent death to which the statute refers. It is conceivable that the idea of death may possess the mind so as to furnish a controlling motive for the disposition of property, although death is not thought to be close at hand. Old age may give premonitions and promptings independent of mortal disease.

Yet age in itself cannot be regarded as furnishing a decisive test, for sound health and purposes associated with life, rather than with death, may motivate the transfer. The words, 'in contemplation of death' mean that the thought of death is the impelling cause of the transfer, and while the belief in the imminence of death may afford convincing evidence, the statute is not to be limited, and its purpose thwarted, by a rule of construction which in place of contemplation of death makes the final criterion to be an apprehension that death is 'near at hand.' . . .

"It is apparent that there can be no precise delimitation of the transactions embraced within the conception of transfers in 'contemplation of death,' as there can be none in relation to fraud, undue influence, due process of law, or other familiar legal concepts which are applicable to many varying circumstances. There is no escape from the necessity of carefully scrutinizing the circumstances of each case to detect the dominant motive of the donor in the light of his bodily and mental condition, and thus give effect to the manifest purpose of the statute.

"We think that the Government is right in its criticism of the narrowness of the rule laid down by the Court of Claims, in requiring that there be a condition 'creating a reasonable fear that death is *near at hand,*' and that '*such* reasonable fear or apprehension' must be 'the only cause of the transfer.' It is sufficient if contemplation of death be the inducing cause of the transfer whether or not death is believed to be near."

FARMERS' LOAN & TRUST CO. v. BOWERS

United States Circuit Court of Appeals, Second Circuit, 1938. 98 F.2d 794. Certiorari denied 306 U.S. 648 (1939).

AUGUSTUS N. HAND, CIRCUIT JUDGE. William Waldorf Astor died at Brighton, England, on October 18, 1919, at seventy-one years of age. On May 25, 1916, he had created a trust in favor of his two sons and their issue in all of the American securities he then possessed which at that time were of the value of $23,-641,262.14, and on January 2, 1917, executed American and English wills. The American will contained a testamentary trust of his residuary estate consisting almost wholly of New York City real estate of the value at the time of his death of $46,421,-545. This real estate became the subject of two deeds of trust dated August 15, 1919, one for Waldorf Astor, the elder son of the settlor, with remainders over, and the other for John Jacob Astor, the younger son, likewise with remainders over. Each of the two reserved to the settlor a tax free annuity of $150,000 payable out of income but if insufficient out of the corpus.

The Farmers' Loan and Trust Company, as trustee under the deeds of trust of the real estate, brought actions against Frank

K. Bowers, a Collector of Internal Revenue, to recover estate taxes to the amount of $5,405,428.99 and interest which had been exacted in respect of each of the foregoing trusts. Upon the death of Frank K. Bowers the actions were continued against his executor as defendant and were tried together.

The main issues before this court are whether the trusts were made "in contemplation of death" within the provisions of the Revenue Act of 1918, sec. 402(c), 40 Stat. 1097, and whether, in view of the plaintiff's evidence, the trial judge erred in his charge to the jury. . . .

Upon the former trial which was held by the court without a jury the trustee obtained judgments for the recovery of the estate taxes. On appeal the judgments were reversed (*Farmers' Loan & Trust Co. v. Bowers,* 2 Cir., 68 F.2d 916), on the ground that the court had erred in failing to apply the proper rule of law in a case where the trust settlements were actuated by more than one substantial motive. The principal defense made upon the first trial was that avoidance of income as well as of estate taxes actuated the creation of the trusts and that saving of income taxes was the controlling motive. While there was some evidence at the first trial that avoidance of a capital levy was also a motive, the trustee introduced far more testimony at the second trial than at the first in respect to the settlor's fear of a capital levy and contended that it furnished the controlling motive for the settlements. It is claimed that if fear of a capital levy was the dominant or weightier motive, the trusts were not made in contemplation of death.

In solving the question whether the transfers were made in contemplation of death, the critical point is whether this court on the former appeal correctly interpreted the statute taxing transfers made in contemplation of death in view of the decision of *United States v. Wells,* 283 U.S. 102, 103—in short whether our former opinion went beyond what was permissible because of the language of the Supreme Court in the latter case.

It is argued with great earnestness on behalf of the appellant trustee that the additional evidence as to Astor's fear of a capital levy made it at least a question for the jury whether that fear was not the dominant motive for making the settlements and we shall assume for purposes of argument that the jury might have found that it was. But the conclusion was inevitable that the desire to avoid estate taxes was also a substantial motive. In dealing with these matters in his charge the court told the jury that if they concluded: ". . . from all the evidence in the case that there were several motives for the transfers—one being to avoid the estate tax, another being to avoid or reduce income tax, and still another being to escape a possible capital levy by the British

Government, and if you are of the belief that the motive of avoiding the estate tax played a substantial part in causing Astor to make the transfers, the transfers must be held to have been made in contemplation of death, and your verdict should be for the defendant."

After the jury had retired to consider their verdict they returned twice for further instructions. The material parts of the record bearing on the court's reply to the jury's questions read as follows:

"THE COURT: . . . The first (inquiry) is: 'A complete and definite definition of the word "substantial" as used in the Judge's charge.'

"I mean by 'substantial' considerable, material, not trifling, not inconsequential. When you speak of a 'substantial' part of a man's estate, you mean—oh, I do not know—10 per cent or 20 per cent or something like that. Now, that is 'substantial.' I would say that 1 per cent is probably not substantial. It means fair-sized.

"The second note is this:

" 'If—a suppositional case—a juror felt that at the time Astor made the trust his motives were estate taxes 35 per cent, income taxes 20 per cent, capital levy, 45 per cent (total) 100 per cent, what should be the jurors' finding under the terms of the Judge's charge?'

"I charged you that if you found that several motives caused Astor to make these trust settlements of August 15, 1919—one motive to avoid estate tax, another motive to avoid income tax, a third motive to avoid a possible capital levy—and if you found that the motive to avoid estate tax contributed a substantial amount or a material amount, or played a considerable part—as it would, if it were 35 per cent—if you can value it in percentage in that way—that then you should find a verdict for the defendant. That such a transfer would be one in contemplation of death. I so charged, and that covers that question." Record pp. 509, 510.

An hour later the jury again returned presenting the following written inquiry to the judge: "Are we obligated to accept the interpretation of the word 'substantial' as defined by his Honor in his charge? Is this definition a matter of law, or of facts?" Page 512.

The following instructions were then given:

"The meaning of the word 'substantial,' whether you take it as a matter of fact or matter of law, is the meaning that I gave, and as it was part of my charge on the law, you can take it as matter of law. I think the part you refer to is where I said that if the purpose of evading estate tax formed a substantial cause in

inducing Astor to create these trust deeds, that then the transfers were in contemplation of death, and you should find a verdict for the defendant. I can only say that that is matter of law, and you may substitute for the word 'substantial,' if you like 'material' or 'considerable.' Those words are synonymous. But that is matter of law, as I charged you in my charge before. That is not matter of fact. It is for you to say whether that motive was substantial, in that sense.

"A JUROR: Your Honor, your definition was 10 or 20 per cent? Is that correct?

"THE COURT: I cannot be pinned down to a figure, gentlemen. One of you suggested figures on a percentage basis. 'Substantial,' 'material,' 'considerable,' 'consequential,' or a 'fair-sized' cause. A fair-sized cause would describe it—not necessarily 51 per cent or 50 per cent. It is hard to figure these things on a percentage basis.

"A JUROR: Out of $100, what would you consider a substantial amount?

"THE COURT: Well, I might consider $20 a substantial amount, or $15 a substantial amount, but that I cannot charge you as matter of law, of course. I think that answers your query. Where I used that expression, I was charging you on the law of the case. There were a couple of sentences in the charge toward the end where I said that if there were several motives, and the motive of evading or escaping or avoiding estate tax was one of the motives, and played a substantial part, a material part, a considerable part, in persuading the donor in this case to make those transfers, that then they were transfers made in contemplation of his death by him, and taxable under the Estate Law, and your verdict should be for the defendant." Record, pp. 512, 513.

From the foregoing extracts from the record it seems evident that the judge did not charge that a motive to avoid estate taxes if found to contribute only 10 per cent of the total motives actuating the transfers would require a verdict for the defendant. On the contrary, he instructed the jury the very last thing that it was for them to say what amounted to a substantial motive, adding that personally he might consider $20 or $15 out of $100 as a substantial portion or (if we take into account his earlier illustration) even 10 per cent. But whatever criticism may be made of the judge's illustrations, the evidence demonstrated that avoidance of estate taxes was a substantial motive for the settlor's action. His English counsel preferred to have powers of revocation inserted in the proposed trusts, arguing that no one could tell what would happen and he might need to retain control of the property. Charles A. Peabody, his American counsel,

warned him that if powers of revocation were inserted in the trusts the corpus would not escape estate taxes. His English counsel Barchard in his letter of December 3, 1918, stated the nub of the matter when discussing the question of what amounts should be reserved for an annuity and whether powers of revocation should be inserted. He said that these things "must depend largely upon what is the main object of the settlement. If it is to economize in American Income Taxes and death duties, I should attach great importance to Mr. Peabody's advice to dispense with the power of revocation, but if it is for another object and the death duties and income taxes are not regarded as of paramount importance I am all in favor of a power of revocation." With this before him, and to escape estate taxes, the settlor decided in December 1918, to eliminate powers of revocation. The trust instruments were finally drawn up without such powers and executed August 15, 1919. The elimination of the powers of revocation to save death duties (amounting to millions of dollars) plainly shows that the transfers were made with a substantial death motive in mind. Accordingly, even if the judge's illustration of 10 per cent be regarded as a direction upon a matter of law and as too low, it made no difference because the facts point clearly to the substantial materiality of estate taxes in the settlor's mind.

The correctness of the charge as to what the jury should regard as a "substantial" motive is not the real problem, but whether the instruction that if "the motive of avoiding the estate tax played a substantial part in causing Astor to make the transfers, the transfers must be held to have been made in contemplation of death, . . ." (Record, p. 505), stated the correct rule of law.

The charge was justified under our former decision unless precluded by the language in *United States v. Wells,* 283 U.S. 102. In that case the Court of Claims had found that "the immediate and moving cause" (page 449) of certain transfers was the carrying out of a policy of making liberal gifts to the decedent's children during his lifetime and that this cause had overcome the presumption, created by the statute, that the transfers were made in contemplation of death. Hughes, C. J., said in his opinion that the test of whether a transfer was made in contemplation of death is always to be found in motive and that a transfer may be so made, though not induced by fear that death is near at hand. . . . There was no statement that the court would have held the transfers free from estate taxes if an important motive for making them had been to save estate taxes. . . . We cannot believe that the general reasoning of the opinion should be taken to exempt gifts *inter vivos* from taxation where an important death motive, such as the avoidance of estate taxes, existed. . . .

It is contended that a transfer is not made in contemplation of death merely because accompanied by the thought of avoiding estate taxes and similarly that transfers are not necessarily made in contemplation of death because in anticipation of the provisions of the donor's will. It may be true that transfers made by one in good health and in the prime of life were not intended by Congress to be within the statute merely because the transferor had the saving of death duties in mind. But motives such as escaping estate taxes or anticipating testamentary provisions when actuating an old man in failing health who was giving away nearly all his remaining property certainly bring the transfers within a statute aimed at reaching substitutes for testamentary dispositions and preventing evasion of estate taxes. . . .

The judgment should be

Affirmed.

Notes and Problems

(A) The constitutionality of the tax on gifts in contemplation of death, although there is not a "transfer" *at* death, was upheld in *Milliken v. United States,* 283 U.S. 15, 20 (1931), where the Court summarily said—"we hold . . . that the inclusion of this type of gifts in a single class with decedents' estates to secure equality of taxation, and prevent the evasion of estate taxes, is a permissible classification of an appropriate subject of taxation." In the same case it was held that such a gift might be taxed at the rates in effect at the date of the donor's death even though those rates were substantially higher than those provided in the statute at the time of the gift.

(B) Does the statute mean contemplation of death or contemplation of a *particular* death? Suppose, for example, a man about to engage in a very hazardous piece of exploration makes a gift of a substantial sum to his wife "in contemplation of" the death he is facing. Against all odds, he returns. Forty years later he dies in an accident at home. Should the property be included in his gross estate in view of the undoubted fact that it was transferred in contemplation of death?

(C) *Factors which may be relevant:*

(1) *Age of the Decedent at the Time of the Gift.* In *Gregg v. United States,* 82 Ct.Cl. 350, 13 F.Supp. 147 (1936), the decedent was 85 years old when he made the gift. In *Lehman v. Commissioner,* 6 B.T.A. 791 (1927), the donor's age was 90. In these cases the tax was sustained. But in *Smart v. United States,* 21 F.2d 188 (W.D.Mo., 1927), the gifts were held not in contemplation of death, though the donor was 85–87 years old when they were made. Would evidence of longevity in the family be relevant on this point? See *Mossman v. Commissioner,* 32 B.T.A. 596 (1935).

(2) *Decedent's Health.* Obviously the presence of a serious disease, or the imminence of a surgical operation, is relevant on the question of contemplation of death. *Harris Trust & Savings Bank v. United States,* 90 Ct.Cl. 17, 29 F.Supp. 876 (1939). It may be shown, though, that the decedent was unaware of his ill-

ness. *Meyer v. United States,* 60 Ct.Cl. 474 (1925). Ordinarily the executor is able to make out a remarkable case to the effect that the decedent was in perfect health and had every reason to expect to live to be a hundred. See *Des Portes v. United States,* 171 F.Supp. 598 (E.D.S.C.1959); *Estate of Holding,* 30 T.C. 988 (1959). Perhaps the extreme example of this is *Nevin v. Commissioner,* 16 B.T.A. 15 (1929), aff'd, 47 F.2d 478 (C.C.A. 3d, 1930), cert. den., 283 U.S. 835 (1931), where large gifts made by the late John Wanamaker at the age of 82 escaped the tax.

(3) ***Length of Time Between the Gift and Death.*** This is plainly relevant but far from conclusive. See *Becker v. St. Louis Union Trust Co.,* 296 U.S. 48 (1935). The extremes are perhaps *Rengstorff v. McLaughlin,* 21 F.2d 177 (N.D.Cal., 1927), where the gift was held to be taxable though made fourteen years before death, and *Sharp v. Commissioner,* 30 B.T.A. 532 (1934), 33 B.T.A. 290 (1935), where trusts were held not made in contemplation of death though only one day intervened between the transfer and the donor's death.

As is pointed out below, transfers made more than three years before death are no longer taxable under this provision. Sec. 2935(b) of the 1954 Code.

(4) ***Concurrent Making of a Will.*** Is the fact that the gift was made in connection with the making of the decedent's will enough to establish the fact of contemplation of death? See *Commissioner v. Estate of Gidwitz,* 196 F.2d 813 (C.A.7th, 1952); *Purvin v. Commissioner,* 96 F.2d 929 (C.C.A.7th, 1938), cert. den. 305 U.S. 626 (1938). Suppose the gift is specifically made as an advancement. A provision on this in Regulations 105, Art. 18.16, last paragraph, was stricken out by T.D. 5148, 1943 Cum.Bull. 1113.

See also *Kroger v. Commissioner,* 145 F.2d 901 (C.C.A.6th, 1944), where the transfer was made in contemplation of a second marriage, when the decedent was 68 years old. He lived 10 years more, but the transfer was held to be in contemplation of death.

(5) ***Establishment of Other Motive.*** It is a rare case that does not leave the lawyer an opening to show that some motive other than the thought of death was the inducement for the gift. Among the instances of legal ingenuity, ordinarily successful, are the following: Activity and plans for the future (*Nevin v. Commissioner, supra; Eckhart v. Commissioner,* 33 B.T.A. 426 (1935)); to avoid interest of prospective wife in the property (*Lippincott v. Commissioner,* 72 F.2d 788 (C.C.A.3d, 1934)); "life motives," as a gift to a daughter on her marriage (*Norris v. Goodcell,* 17 F.2d 181 (S.D.Cal.1927)), or Christmas gifts (*Benson v. Commissioner,* B.T.A. memorandum decision, August 31, 1938); to avoid risks from contemplated stock market operations (*Colorado Nat. Bank v. Commissioner,* 305 U.S. 23 (1938)). This list might be extended almost indefinitely.

Many cases on this problem are collected in Notes in 120 A.L.R. 170 (1939), and 148 A.L.R. 1051 (1944). See also Lowndes and Kramer, Federal Estate and Gift Taxes 64–83 (1956); Barry, "The Taxation of Transfers in Contemplation of Death," 10 Hastings L.J. 370 (1959).

(D) A woman died, leaving one third of her property to her husband. Some time later, but before the final distribution of

the estate, the husband formally renounced the gift to him, with the result that the property passed to his children as heirs of his wife. The husband died shortly afterwards. If the renunciation was in contemplation of death, should the property be included in the husband's gross estate? In other words, was there a gift? See *Brown v. Routzahn,* 63 F.2d 914 (C.C.A.6th, 1933), cert. den. 290 U.S. 641 (1933), noted in 33 Col.L.Rev. 1269 (1933). See also *Routzahn v. Brown,* 95 F.2d 766 (C.C.A.6th, 1938); Kay, "Renunciations, Disclaimers and Releases," 35 Taxes 767 (1957).

(E) See, generally, Pavenstedt, "Taxation of Transfers in Contemplation of Death: A Proposal for Abolition," 54 Yale L.J. 70 (1944); Harriss, "Gifts in Contemplation of Death," 19 Taxes 151, 216 (1941); Atlas, "Gifts in Contemplation of Death," 23 Taxes 421 (1945); Lowndes and Rutledge, "An Objective Test of Transfers in Contemplation of Death," 24 Tex.L.Rev. 134 (1946).

AARON'S ESTATE v. COMMISSIONER

United States Court of Appeals, Third Circuit, 1954. 224 F.2d 314.

HASTIE, CIRCUIT JUDGE. These petitions require review of a decision of the Tax Court that the value of certain property irrevocably and completely transferred in trust by Charles Aaron during his lifetime is includable upon his death in his gross estate as a transfer in contemplation of death within the meaning of Section 811(c)(1)(A) of the Internal Revenue Code of 1939. Taxability under the special provisions of Section 811(g) covering the proceeds of life insurance was not adjudicated by the Tax Court and is not considered in this opinion.

In 1931, the settlor transferred to his nephew, Marcus Aaron, as trustee, certain policies of insurance upon the settlor's life together with valuable government and corporate bonds. The transactions involved the creation of four distinct trusts, differing somewhat in amount but with equivalent relevant provisions, for the settlor's grandnephew and three grandnieces, all of whom were small children at that time. In aggregate the policies insured the life of the settlor for about $450,000. The face value of the bonds was nearly $300,000. Because the relevant provisions of the policies are alike, the trusts have been considered together throughout this proceeding.

The trustee was directed to apply the income of each trust first to the payment of premiums on the insurance policies. Any income not required for that purpose was to be paid to the beneficiaries as they should come of age. However, during the infancy of the beneficiaries the trustee was also authorized, within his discretion, to apply any income not needed for premium payments toward their education and maintenance. He was also given discretionary power to sell any of the trusted property and to make appropriate reinvestments.

Each trust was to terminate by the transfer of the entire trust estate to the beneficiary upon the death of the settlor or on the thirtieth birthday of the beneficiary, whichever should be later. The settlor was 58 years of age when the trusts were executed in 1931. He died suddenly of a coronary occlusion in 1947 at the age of 74. At that time the oldest of the beneficiaries was aged 20.

For each year from 1931 to the settlor's death, the income from each trust was less than the premiums on the insurance policies which constituted part of its corpus. Accordingly, during this period the trustee sold a substantial part of the securities he held in trust and used the proceeds, some $107,000, to pay premiums in excess of the income yielded by the securities. At the same time he permitted very substantial dividends and interest earned by the insurance policies to accumulate. No income was paid to the beneficiaries during the settlor's life.

The settlor remained a bachelor throughout his life. Before he became 50, he had accumulated a substantial fortune, largely through participation in family business ventures. His father and later his elder brother Marcus, the grandfather of the present beneficiaries, had been generous in making available to him the economic opportunities which were to prove so profitable. He, in turn, from 1920 to 1935 made numerous gifts aggregating about $1,700,000 to the two children and several grandchildren of Marcus. All such gifts to infant beneficiaries were made in trust and so restricted that the beneficiaries would not receive the corpus until they should become 30 or 35 years of age. The settlor repeatedly expressed his belief and concern that children and young adults might lack judgment and discretion in the handling of large sums of money.

In these circumstances the Tax Court found one consideration decisive in proving that the transfer was made in contemplation of death. In the Tax Court's language, the settlor "knew and intended that the trusts would not provide any economic or other benefits for the children until his death would bring into the trusts the proceeds of the insurance on his life and relieve the trusts of the expense of the premiums. * * * That was what the decedent intended and that was the way in which the transfers were made by him in contemplation of his death." But as the Tax Court itself recently recognized in *Estate of Charlotte A. Hopper*, 1954, 22 T.C. 138, it is well settled that postponement of the beneficiary's enjoyment of a complete and irrevocable inter vivos transfer in trust until the settlor's death is not a sufficient basis for a finding that the transfer was made in contemplation of death. *Cf. Colorado Nat. Bank v. Commissioner*, 1938, 305 U.S. 23. We are concerned here with the applicability of that principle to cases where the corpus of the trust

includes insurance upon the life of the settlor which in its nature increases in value upon his death. Here again the Tax Court itself has pointed out that although "life insurance policies are inherently testamentary in nature, * * * this fact alone does not create an inference that a *transfer* of rights in such policies, as distinguished from the *creation* of such rights, is in contemplation of death." *Estate of Wilbur B. Ruthrauff*, 1947, 9 T.C. 418, 427. However, in very recent decisions the Tax Court seems to be adopting the view expressed by Judge Learned Hand in *Garrett's Estate v. Commissioner*, 2 Cir., 1950, 180 F.2d 955, that the character of the property involved in a trust of insurance on the settlor's life is sufficient in itself to create an inference of transfer in contemplation of death in the absence of any significant evidence of motivation connected with life. *Estate of Frank W. Thacher*, 1953, 20 T.C. 474; *Estate of Lillie G. Hutchinson*, 1953, 20 T.C. 749. But in these very cases, the Court takes care not to discount affirmative evidence of motivation connected with life merely because the property transferred is life insurance. The inference drawn from the nature of the property has but minimal probative value when opposed by any significant showing of motivation connected with life.

In this case, we think the Tax Court has failed to recognize the limited probative value of this inference from the nature of the property and at the same time has failed to give proper effect to its own findings which indicate motivation connected with life.

With ample justification in the evidence, the Tax Court made the following finding: "The decedent became concerned about the security of the family fortunes after the stock market crash of 1929. He had always considered life insurance the most secure form of saving. He placed $455,000 of insurance on his own life, most of which had been taken out prior to 1929, in trust for the three grandnieces and one grandnephew, together with the bonds, to provide the beneficiaries with economic security and financial independence when they became old enough to have those things count in their lives." We think this is a very significant finding of motivation connected with life. Contemplation of our economy in the early 1930's was calculated to cause persons of means grave apprehension about the future security of their families. It was a matter of concern to conservative businessmen no less than speculators that property in as secure form as possible be set aside and irrevocably committed to the use and benefit of the children of the depression era. Sharing that concern, the settlor undertook to make sure that substantial sums would be available to his infant grandnieces and grandnephews in their maturity. Similar motivation has often been the basis of a finding that a transfer of property was not in con-

templation of death. E. g., *Colorado Nat. Bank v. Commissioner*, 1938, 305 U.S. 23; *Estate of Frank W. Thacher*, 1953, 20 T.C. 474; *Estate of Louis Richards*, 1953, 20 T.C. 904, affirmed per curiam, 9 Cir., 1955, 221 F.2d 808; *Estate of Verne C. Hunt*, 1950, 14 T.C. 1182. It is particularly significant here as an explanation of the action of a vigorous and active man in his middle years placing property worth over $700,000 irrevocably beyond his own control.

In addition, although the Tax Court made a permissible finding that the settlor did not contemplate the payment of trust income to the beneficiaries during his lifetime, it is also a fact that he did so establish the trusts that this was a possibility. He explicitly provided that income after the payment of premiums could be used for the education and maintenance of the beneficiaries and must be paid to them when they should become 21. In fact more than $100,000 in dividends and interest earned by the trusted insurance policies had accumulated at his death. The Commissioner properly recognizes in his brief that "the trust instruments conferred powers upon the trustee broad enough to cover payment of premiums out of insurance interest and dividends, and conversion of policies into paid-up insurance; and exercise of such powers might have made excess income available for payments to beneficiaries during decedent's lifetime." Granting that the settlor thought it improbable that the financial circumstances of the beneficiaries or their parents would so deteriorate as to necessitate the use of trust income for the support of the beneficiaries during their minority, he deemed it wise nevertheless to provide for this contingency. Although not controlling in itself, this certainly is an additional indication of motivation connected with life.

Moreover, the settlor was 58, while the beneficiaries were from four years to 10 months old, when the trusts were established. His normal life expectancy suggests that as a practical matter the postponement of control over the corpus until his death was not likely to extend any trust beyond the thirtieth birthday of the beneficiary. And he already had indicated in other giving that, regardless of his own survival, he considered it in the best interest of his infant kinsmen that they not receive large sums until they should reach their thirties. Thus the whole picture suggests that the maturing of the beneficiaries rather than his own passing was the matter of principal concern to the settlor in fixing the time when the beneficiaries should acquire control of the trust estate.

In summary, we think the case amounts to this. The petitioner made a significant showing of motivation connected with life in the establishment of these trusts. As countervailing indicia, the Tax Court was able to discover nothing except the

With the decision in *Allen v. Trust Co. of Georgia,* compare *Theopold v. United States,* 164 F.2d 404 (C.C.A.1st, 1947). In that case, the settlor on creating a trust reserved power to amend it "so that it will more clearly express my actual intentions" if he should regard it as desirable, "as to which I shall be the sole judge." He exercised the power, in relatively small ways, five times before he died. The Court held that he had not reserved a power to alter or amend the trust, and that it was not taxable in his estate. See also *State Street Trust Co. v. United States,* 263 F.2d 635 (C.A.1st, 1959).

If dividend declared after the gift but before
not included in the gross estate of the don

McGEHEE v. COMMISSIONER

United States Court of Appeals, Fifth Circuit, 1958. 260 F.2d 818.

JONES, CIRCUIT JUDGE. The Tax Court, whose decision we here review, thus states the Federal estate tax issues presented:

> "(1) Whether the value of stock dividends paid on stock between the time of its transfer in contemplation of death and the death of the transferor is includible in decedent's gross estate under section 811(c) Internal Revenue Code of 1939, and (2) whether a certain devise and bequest by the decedent results in a marital deduction under section 812 (e)."

The Tax Court's opinion is reported in 28 T.C. 412.

From a stipulation of facts it appears that Delia Crawford McGehee made gifts in the years 1947, 1948 and 1949, of shares of the stock of Jacksonville Paper Company. She died on February 6, 1950. In 1948 and 1949 the corporation declared stock dividends. Stock certificates evidencing the dividends on the stock which had been the subject of the prior gifts were issued and delivered to the donees. These dividends represented a capitalization of current earnings. The issuance of such dividends was in keeping with the policy of the corporation. It had capitalized current earnings by the distribution of a stock dividend in each of the years 1941 through 1949. The company had never declared a dividend payable in cash or property. The executor conceded that the transfers of the shares of stock made by Mrs. McGehee were made in contemplation of death and hence to be included as a part of her estate for Federal estate tax purposes. The Commissioner of Internal Revenue asserted and the Tax Court held that shares issued as stock dividends were also to be included. A minority of the Tax Court disagreed. The executor, in his petition for review of the Tax Court's decision, insists that this holding is erroneous.

The Tax Court decision is apparently the only reported American case upon the stock dividend question. In the English case of Attorney General v. Oldham, 1940, 1 K.B. 599, aff. 3. All Eng. Rep. 450, upon facts similar to those here present, it was held

nature of the property and the postponement of the beneficiaries' control and enjoyment. In the circumstances, these were not enough to justify a conclusion that the transfer was made in contemplation of death.

The decision will be reversed and the cause remanded for further proceedings consistent with this opinion.

Notes

(A) For some time, there seemed to be developing a rule or doctrine that transfers of life insurance were taxable as gifts in contemplation of death since they were inherently testamentary in nature. See *Estate of Garrett v. Commissioner,* 180 F.2d 955 (C.A.2d, 1950). See also Guterman, "Transfers of Life Insurance and the Federal Estate Tax," 48 Col.L.Rev. 37 (1948); Hunt, "Federal Estate Tax—Transfers of Life Insurance in Contemplation of Death," 47 Mich.L.Rev. 811 (1949). The principal case refuses to accept this tendency, though it had been followed by the Tax Court. The importance of this question is now minimized since the change in the statute removing any gift from the tax which is made more than three years prior to death.

(B) *City Bank Farmers' Trust Co. v. McGowan,* 323 U.S. 594 (1945), involved the estate of a decedent who had been incurably insane for nine years before she died in 1935. She had a large annual income. She was over 70 years of age, but in good physical health. She had a living daughter and three grandchildren. The appropriate state court, acting in accordance with state law, entered orders under which substantial amounts of the income were paid to the daughter and to the guardian of the grandchildren. The amounts so paid were considerably in excess of the amounts required for the support of these persons. The aggregate of the allowances over several years came to $1,377,866.67.

The Supreme Court held that the payments to the daughter and to the guardian of the grandchildren, in excess of $6,000 per year, were properly held by the District Court to have been in contemplation of death.

(C) In *Allen v. Trust Co. of Georgia,* 326 U.S. 630 (1946), it appeared that the decedent had created two trusts in 1925, and had added securities to each trust in 1934. He paid gift taxes at both times, and intended all of the transfers to be final and complete. The trust instruments, however, retained a power of amendment which could be exercised only with the consent of the trustee and the beneficiary. In 1935 it became evident that the retention of such a power might leave the property taxable in the decedent's estate, and in 1937 the decedent renounced the power to amend the trusts. He was in good average health, for a man of his age at the time. He died in 1938 at the age of 82. The Court sustained findings made below that the release of the power was not a transfer in contemplation of death. It said: "On these facts, his desire to avoid death taxes does no more than establish that he did not want his plan to underwrite the necessities of his children and grandchildren jeopardized. His desire to make adequate provision for them remained the dominant motive, or so the triers of fact could properly find."

that a stock dividend declared and paid after an inter vivos gift of stock made in contemplation of death was not a part of the gift subject to the estate tax imposed with respect to the estate of the donor. See 1 Paul, Federal Estate and Gift Taxation 277, § 6.23 n; 54 Harv.L.Rev. 512.

The Tax Court majority were of the belief that the gift of stock transferred a proportional interest in the assets, business and affairs, and that this interest, so transferred, was unaffected by the dividends paid in stock. In support of this view the Tax Court cited *Eisner v. Macomber,* 252 U.S. 189. This is the leading case holding that a dividend paid in stock of the same kind as that upon which it is declared is not subject to taxation as income to the stockholder. The doctrine has been questioned. *Helvering v. Griffiths,* 318 U.S. 371; Lowndes & Kramer, Federal Estate and Gift Taxes, 439. We do not think that because a stock dividend is not taxed as income to the stockholder it must necessarily be included as a part of a gift made in contemplation of death, of the shares upon which it was declared. There are, we would say, substantial differences between the two situations.

The statute here applicable provides:

> "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States—* * *
>
> "(c) Transfers in contemplation of, or taking effect at, death.
>
> "(1) General rule. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise—
>
> "(A) in contemplation of his death; * * *" 26 U.S.C.A. (I.R.C.1939 as amended) § 811(c)(1)(A).

It is the interest of the decedent of which a transfer has been made which is to be included in the taxable estate of the donor. It seems unnecessary to decide whether the subject matter of the transfer was regarded as a "proportionate interest in the corporation, its business and its assets", as the Tax Court held it to be, or as "specific shares of stock" which the Tax Court held it was not. The stock dividends were declared out of profits of the corporation earned subsequent to the gifts and hence were not a proportionate part of the corporation's assets at the time of the gift. This being so, it follows that the deceased donor never had any interest in the shares which were distributed as stock dividends or in the corporate earnings which the dividends capitalized. Although the tax is to be measured by the value of the transferred

property as of the date of the donor's death, this does not mean that, for the purpose of determining what property was transferred, the gifts should be regarded as having been made as of the date of death. It has been held, and properly so, that income earned by previously taxed property should not be regarded as previously taxed property. *Gray v. Commissioner,* 19 B.T.A. 455. So also, we think, a stock dividend distributed as a capitalization of income of a corporation earned subsequent to a gift of the shares upon which the dividend was declared should not be regarded as a part of the gift.

Eisner v. Macomber, supra, is an income tax case construing a statute which was limited in its operation by the confines of the Sixteenth Amendment. No like restrictions are here applicable. *Knowlton v. Moore,* 178 U.S. 41; *New York Trust Co. v. Eisner,* 256 U.S. 345. The case is not persuasive as to the question before us.

We conclude that of the stock of Jacksonville Paper Company, only 774 shares should have been included in the gross estate of the decedent. Cases involving stock splits or stock dividends capitalizing corporate profits earned prior to the transfer might require different treatment. We do not think that this determination is in conflict with the holding of this Court in *Igleheart v. Commissioner,* 5 Cir., 1935, 77 F.2d 704. . . .[1]

Reversed and remanded.

Notes

(A) The question of the amount to be included in the gross estate in connection with a gift in contemplation of death is left obscure in the statute, and there is not much help in the Regulations. See sec. 20.2035–1(e) of the Estate Tax Regulations. It is there provided that "neither income received subsequent to the transfer nor property purchased with such income is considered." This, as to income on the gift, is in accordance with *Commissioner v. Gidwitz' Estate,* 196 F.2d 813 (C.A.7th, 1952), and *Burns v. Commissioner,* 177 F.2d 739 (C.A.5th, 1949). *Commissioner v. McDermott's Estate,* 222 F.2d 665 (C.A.7th, 1955), is in accord, although it arose under sec. 811(d) of the 1939 Code (corresponding to sec. 2038 of the 1954 Code). It was there held that interest earned on the corpus after creation of a trust was not includable in the gross estate where the trust was irrevocable. The case was noted in 54 Mich.L.Rev. 577 (1956), and in 51 Northwestern U.L.Rev. 149 (1956).

(B) Is the principal case sound? How does one tell whether a stock dividend is "declared out of profits of the corporation earned subsequent to the gifts"? What would have been the situation if there had been no stock dividend? For general dis-

[1] The portion of the opinion dealing with the question of marital deduction is omitted.

cussion, see "Estate Tax Includability of Stock Dividends on Shares Transferred in Contemplation of Death," 25 U. of Chi.L. Rev. 372 (1958).

(C) Suppose that the property given is sold between the date of the gift and the date of the death. Should the proceeds be included in the gross estate, or should the property given be valued at the date of death despite the fact that it has been sold? If the sales proceeds are reinvested, should the original property be valued for inclusion in the gross estate, or the property subsequently acquired? Cf. *Estate of Igleheart,* 28 B.T.A. 888 (1933), aff'd 77 F.2d 704 (C.A.5th, 1935); *Estate of Kroger,* Memo. B.T. A. (1943), aff'd 145 F.2d 901 (C.C.A.6th, 1944), cert. den. 324 U.S. 866 (1945).[1]

(D) Suppose the gift is in cash, and is lost in whole or in part, before the decedent dies. In *Humphrey's Estate v. Commissioner,* 162 F.2d 1 (C.A.5th, 1947), cert. den. 332 U.S. 817 (1947), half of a gift of cash had been lost in a speculative business by the time the donor died. The court held that the entire value of the gift at the date it was made was includible in the gross estate.

(E) *Finality of Decision of Trial Court.* The Supreme Court has held that the decision of the trier of the facts on the question of contemplation of death must be upheld, unless there is no substantial evidence to support the finding. *McCaughn v. Real Estate Land Title & Trust Co.,* 297 U.S. 606 (1936) (District Court); *Colorado National Bank v. Commissioner,* 305 U.S. 23 (1938) (Board of Tax Appeals). Thus, as a practical matter, with increasingly rare exceptions, the place to win (or lose) a contemplation of death case is in the trial court. How far is contemplation of death a question of fact? Suppose, for instance, that all the underlying facts are stipulated.

(E) *The Two-Year Presumption. (1916–1950).* Obviously, contemplation of death is an unsatisfactory sort of concept to have in a tax statute. In operation it has bred much litigation and small revenue. Each case necessarily turns on its own facts, but in the past it has been very difficult for the Government to find a set of facts within the statute. Up to 1932, the Government had been successful in twenty reported cases, involving gifts of $4,250,000, and unsuccessful in seventy-eight reported cases, involving gifts largely in excess of $120,000,000. See Mr. Justice Stone, dissenting, in *Heiner v. Donnan,* 285 U.S. 312, 343–346 (1932). The relative success has doubtless improved since that time, but not much.

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[1] See 1 Paul, Federal Estate and Gift Taxation, sec. 6.23 (1942); "The Federal Estate Tax and Income Accumulated in a Trust Created in Contemplation of Death," 58 Yale L.J. 313 (1949); Barrett, "Valuation for Estate Tax Purposes of Property Transferred in Contemplation of Death," N.Y.U. Ninth Annual Institute on Federal Taxation (1951) 141.

From the beginning, the contemplation of death section included an express provision that any transfer "made by the decedent within two years prior to his death . . . shall, unless shown to the contrary, be deemed to have been made in contemplation of death." In section 302(c) of the Revenue Act of 1926, this rebuttable presumption was made conclusive, by providing that transfers in excess of $5,000 made within two years of death "shall be deemed and held to have been made in contemplation of death." Although this was cast in the form of a "conclusive presumption," its effect was simply to provide a tax on all gifts made within two years of death without regard to their motive. In *Heiner v. Donnan,* 285 U.S. 312 (1932), however, the Court held the new statute to be unconstitutional on the grounds that it (1) prevented the taxpayer from proving the truth, and (2) was a wholly arbitrary and unreasonable classification of gifts.[1] Mr. Justice Stone's powerful dissenting opinion, in which Mr. Justice Brandeis concurred, has been referred to above. If the occasion should arise, it would seem that this is indeed "a case which the present Court may inter with few qualms." 53 Harv. L.Rev. at 495 (1940).

So far as taxpayers in general were concerned, this was hardly a notable victory, for it resulted almost immediately, in a tax on *all* gifts, imposed by the Revenue Act of 1932. This has, of course, made the issue of contemplation of death a less important one, since the gift will be caught by one tax if not by the other.

The Three-Year Limitation and Presumption (1950 to date). The situation has now been further modified by the provision appearing in the last clause of sec. 2035(b) of the 1954 Code, which was added to the 1939 Code in 1950. Under this, no gift made more than three years prior to the date of the decedent's death shall be treated as a gift in contemplation of death. In the situation where the gift was made within three years of the decedent's death, then it "shall, unless shown to the contrary, be deemed to have been made in contemplation of death."

Is this a desirable provision? Is the three year period a proper one? Would it be desirable to carry through with this amendment with a further provision under which all gifts made within three years of death would be taxable—eliminating the concept of contemplation of death entirely?

The new provision is discussed in Pavenstedt, "The Limitation of Transfers in Contemplation of Death by the Revenue Act of 1950," 49 Mich.L.Rev. 839 (1951).

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1 The Court had already reached a similar result with respect to a six-year conclusive presumption in the Wisconsin inheritance tax in Schlesinger v. Wisconsin, 270 U.S. 230 (1926).

Other Inter Vivos Transfers

When the estate tax was first enacted in 1916, the only provision dealing with inter vivos transfers was in very general terms. It provided that the gross estate should include property "to the extent of any interest therein of which the decedent has at any time made a transfer . . . in contemplation of or intended to take effect in possession or enjoyment at or after his death." Transfers in contemplation of death have already been dealt with. The other phrase—"intended to take effect in possession or enjoyment at or after his death"—is the generating source for the other provisions now found in the statute, though this phrase has itself now disappeared from the law.

The material which follows is arranged in the order in which the applicable provisions now appear in the statute, as follows:

Retained life estate. Sec. 2036.
Transfers taking effect at death. Sec. 2037.
Revocable transfers. Sec. 2038.
Annuities. Sec. 2039.

In considering this material, however, it should be remembered that this statutory arrangement is a new one. The various problems developed side by side, and cases in one of these fields had some influence in the others.

In presenting the material in the casebook, there could be at least two possible arrangements. One would be to put it all in chronological order. Then the student could see the development of the law, both in cases and by statute, and could follow through the developments as was done by the practitioners of the period. Another arrangement is by topics, in accordance with the present arrangement of the statute. This is the arrangement which has been adopted here, because it is believed that it will assist the student in understanding the material and in relating it to the present statute. This involves a certain loss of chronological continuity. The student should endeavor to supply this after he has been through the next portion of the casebook.

In reading the cases he should recall that the statutory provision actually considered by the court may be different from that found in the 1954 Code. The statutory provision is quoted in each case, and should be compared with the present statutory language.

4. Retained Life Estates

Sec. 2036 of the 1954 Code

NICHOLS v. COOLIDGE

Supreme Court of the United States, 1927. 274 U.S. 531.

MR. JUSTICE MCREYNOLDS delivered the opinion of the Court.

Defendants in error sued to recover additional federal taxes exacted of the estate in their keeping. The cause was heard upon an agreed statement; judgment went for them on a directed verdict; and this writ of error, allowed April 3, 1925, brings the matter here. In a comprehensive charge the trial court interpreted the law, but gave no further opinion. 4 F.2d 112.

Mrs. Julia Coolidge, of Massachusetts, died January 6, 1921. As required by the Revenue Act approved February 24, 1919, c. 18, 40 Stat. 1057, 1096, the executors returned a schedule to the Collector. He estimated the gross estate at $180,184.73 and allowed $77,747.74 deductions. They paid the amount assessed upon the balance. Their return did not include certain property transferred by the decedent through duly executed deeds and without valuable consideration, some to trustees and some directly to her children. The Commissioner of Internal Revenue held that under section 402(c) the value of all this property at her death must be included in the gross estate. He raised the assessment accordingly and demanded the additional tax—$34,662.65—here challenged.

July 29, 1907, Mrs. Coolidge and her husband owned certain real estate in Boston, also valuable personal property, which they transferred without consideration to trustees, who agreed to hold it and pay the income to the settlors, then to the survivor, and after his death to distribute the corpus among the settlor's five children or their representatives. The deed directed that the interest of any child predeceasing the survivor should pass as provided by the statute of distribution "in effect at the time of the death of such survivor." The trustees were authorized to sell the property, to make and change investments, etc. April 6, 1917, the settlors assigned to the children their entire interest in the property, especially any right to the income therefrom. At the death of Mrs. Coolidge the trustees held property worth $432,155.35, but through sales and changes much of what they originally received had passed from their possession.

May 18, 1917, by deeds purporting to convey the fee Mrs. Coolidge—her husband joining—gave their five children two parcels of land long used by her for residences. Contemporaneously the grantees leased these parcels to the conveyors for one year at

nominal rental, with provision for annual renewals until notice to the contrary. All parties understood that renewals would be made if either lessee wished to occupy the premises. When Mrs. Coolidge died the value of this property was $274,300.

Plaintiff in error now maintains the above-described transfers by Mrs. Coolidge were intended to take effect in possession or enjoyment at or after death, within the ambit of section 402(c), Act February 24, 1919, and that the value at her death of the property held by the conveyees constituted part of her gross estate.

The court below held the transfer of the residences (1917) was absolute; the right to possess or enjoy them did not depend upon death; and their value constituted no part of the gross estate. Also, that under the statute the value of the property conveyed to trustees in 1907 or resulting therefrom must be included in the gross estate, but, thus construed, the Act went beyond the power of Congress.[1]

Concerning transfer of the residences in 1917, the trial court charged—

"I do not have much difficulty in reaching a conclusion respecting the deeds of the Boston and Brookline real estate, and I will first consider the claims of the parties respecting those transfers.

"The deeds conveyed, with warranty covenants, absolute and indefeasible title to the real estate without any valid reservations, conditions or restrictions whatsoever.

"The leases, executed the same day, were for one year or any renewal thereof but were always subject to the right in the lessors to terminate the term during any year by giving the notice as therein provided. It is conceded that the parties contemplated that the premises would be enjoyed by the decedent and her husband so long as they might desire to use them for residential purposes, but the decedent had no valid agreement to that effect. Her rights must be held to be governed by the term of the lease. If it could be said that the grantees did not come into full possession and enjoyment of the estate at the time of the conveyances—and I am inclined to the opinion that they did—their right to come into full possession did not depend in the slightest degree upon the death of the grantor. The effect of this transaction was to vest in the five sons named in the deed full and complete title to the property including the right of disposition. They had a right to sell the property subject to the lease and had all rights incident to ownership. There was here a gift completed during the lifetime of the donor. The act of 1918 did not purport to tax such gifts.

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1 Quotations from the Revenue Act of 1918 are omitted.

"I have reached the conclusion, therefore, that respecting the property conveyed by the deed, the facts of this case do not bring the property within the reach of the statute and that the Commissioner of Internal Revenue was without authority to include the value of it as a part of the gross estate. I, therefore, give the following instructions, as requested by the plaintiffs: The real estate referred to in the second count of the declaration was not a part of the net estate of Julia Coolidge within the meaning of the Revenue Act of 1918."

We agree with this conclusion and accept as adequate the reasons advanced to support it.

Counsel for the United States argue that the challenged subsection only undertakes to tax the transfer from the dead and merely uses the gross estate to measure the charge. Taken together, sections 402, 408 and 409 disclose definite purpose to do much more than tax this transfer.

Section 402 directs that the gross estate shall be ascertained by including (among other things) the value at his death of all property "to the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death (whether such transfer or trust is made or created before or after the passage of this Act) except in case of a *bona fide* sale for a fair consideration in money or money's worth." The language of this section inhibits the conclusion that only subsequent transfers are to be included. Under *Lewellyn v. Frick,* 268 U.S. 238, 251, only such transfers come within section 402(f). *Schwab v. Doyle,* 258 U.S. 529, 536, confined section 202(b), Act September 8, 1916, c. 463, 39 Stat. 756, 777—prototypes of section 402(c), Act 1919—to subsequent transfers. The emphatic words, "whether such transfer or trust is made or created before or after the passage of this Act," added by the latter Act, evidently were intended to exclude a like construction. . . .

For the United States it is said that the imposition under consideration is an exercise of the federal taxing power and is imposed upon a transmission of property by death. Also, that what Congress intended was to provide a measure for the tax which would operate equally upon all those who made testamentary dispositions of their property, whether this was by will or intestacy or only testamentary in effect; the immediate purpose was not to prevent evasions, for the statute applies to transactions completed when there was none to be evaded. And the conclusion is that the measure adopted is reasonable, since the specified transactions are testamentary in effect.

But the conveyance by Mrs. Coolidge to trustees was in no proper sense testamentary, and it bears no substantial relationship to the transfer by death. The mere desire to equalize taxation cannot justify a burden on something not within congressional power. The language of the statute is not consistent with the idea that it utilizes the gross estate merely to measure a proper charge upon the transfer by death. See *Lewellyn v. Frick, supra. Frick v. Pennsylvania,* 268 U.S. 473, 494, rejected a somewhat similar claim, and said—"Of course, this was but the equivalent of saying that it was admissible to measure the tax by a standard which took no account of the distinction between what the State had power to tax and what it had no power to tax, and which necessarily operated to make the amount of the tax just what it would have been had the State's power included what was excluded by the Constitution. This ground, in our opinion is not tenable. It would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail."

The exaction is not a succession tax like the one sustained by *Scholey v. Rew,* 23 Wall. 331. *Keeney v. New York,* 222 U.S. 525. The right to become beneficially entitled is not the occasion for it. There is no claim that the transfers were made in contemplation of death or with purpose to evade taxation. The provision applicable in such circumstances is not relied on and the extent of congressional power to prevent evasion or defeat of duly-imposed exactions need not be discussed.

Certainly, Congress may lay an excise upon the transfer of property by death reckoned upon the value of the interest which passes thereby. But under the mere guise of reaching something within its powers Congress may not lay a charge upon what is beyond them. Taxes are very real things and statutes imposing them are estimated by practical results. . . .

The statute requires the executors to pay an excise ostensibly laid upon transfer of property by death from Mrs. Coolidge to them but reckoned upon its value plus the value of other property conveyed before the enactment in entire good faith and without contemplation of death. Is the statute, thus construed, within the power of Congress?

Undoubtedly, Congress may require that property subsequently transferred in contemplation of death be treated as part of the estate for purposes of taxation. This is necessary to prevent evasion and give practical effect to the exercise of admitted power, but the right is limited by the necessity.

Under the theory advanced for the United States, the arbitrary, whimsical and burdensome character of the challenged tax is plain enough. An excise is prescribed, but the amount of it is

made to depend upon past lawful transactions, not testamentary in character and beyond recall. Property of small value transferred before death may have become immensely valuable, and the estate tax, swollen by this, may leave nothing for distribution. Real estate transferred years ago, when of small value, may be worth an enormous sum at the death. If the deceased leaves no estate there can be no tax; if, on the other hand, he leaves ten dollars both that and the real estate become liable. Different estates must bear disproportionate burdens determined by what the deceased did one or twenty years before he died. See *Frew v. Bowers,* 12 F.2d 625.

This court has recognized that a statute purporting to tax may be so arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment. *Brushaber v. Union Pacific R. R.,* 240 U.S. 1, 24; *Barclay & Co. v. Edwards,* 267 U.S. 442, 450. See also, *Knowlton v. Moore,* 178 U.S. 41, 77. And we must conclude that section 402(c) of the statute here under consideration, in so far as it requires that there shall be included in the gross estate the value of property transferred by a decedent prior to its passage merely because the conveyance was intended to take effect in possession or enjoyment at or after his death, is arbitrary, capricious and amounts to confiscation. Whether or how far the challenged provision is valid in respect of transfers made subsequent to the enactment, we need not now consider.

The judgment of the court below is

Affirmed.

MR. JUSTICE HOLMES, MR. JUSTICE BRANDEIS, MR. JUSTICE SANFORD, and MR. JUSTICE STONE concur in the result.

Notes and Problems

(A) Why did the Government assert a tax (with respect to the trust) on these facts? Why did the majority place no reliance on the conveyances made to the children in 1917? Is this the ground upon which the minority concurred? Is the case necessarily a decision that the interests were as a matter of construction within the statute?

The suggestion in the opinion that a different result might be reached under an inheritance tax was not accepted when that question came up under the Massachusetts tax involving the same transactions. *Coolidge v. Long,* 282 U.S. 582 (1931).

(B) Would the decision with respect to the residences be followed today? What is the basis for the statement in the opinion that "If the deceased leaves no estate [meaning property owned by the decedent at his death] there can be no tax"? Is it sound?

MAY v. HEINER

Supreme Court of the United States, 1930. 281 U.S. 238.

MR. JUSTICE MCREYNOLDS delivered the opinion of the Court.

By a written instrument dated October 1st, 1917, Pauline May, wife of Barney May, "transferred, set over and assigned" to him and others, as trustees, (with power to change the investments) certain described securities—bonds, notes, corporate stocks, and money—in trust, to collect the income therefrom and after discharging taxes, expenses, etc., to pay the balance "to Barney May during his lifetime, and after his decease, to Pauline May during her lifetime, and after her decease, all the property in said Trust, in whatever form or shape it may be, shall, after the expenses of the Trust have been deducted or paid, be distributed equally among" her four children, their distributees, or appointees.

Mrs. May died March 25, 1920. Thereafter the Commissioner of Internal Revenue, purporting to proceed under authority of the Revenue Act of 1918, Title IV, 40 Stat. 1057, 1096, 1097, demanded that her executors pay additional taxes reckoned upon the value of the property held under the above-described trust instrument. Having paid the required sum, the executors—petitioners here—asked that it be refunded. By order of February 20, 1924, the Commissioner denied their request. In support of this action he said—

"This trust was included in decedent's gross estate on final audit and review on the ground that it was intended to take effect in possession or enjoyment at or after death. In this case the principal of the trust fund could not take effect in possession until the death of the decedent. According to the provisions of the trust agreement, if the decedent's husband died before her, the income was to be paid to her until her death. The gift of the principal, therefore, could not take effect during the decedent's lifetime. This case comes literally within the terms of the statute, and it has been held by a number of courts in different States that such a transfer as this is taxable, these cases being decided under statutes using the same language as is contained in the Federal Estate Tax Law."

Seeking to enforce their claim the executors sued the Collector in the District Court, Western District of Pennsylvania; judgment in his favor was affirmed by the Circuit Court of Appeals. The matter is here upon certiorari.

The record fails clearly to disclose whether or not Mrs. May survived her husband. Apparently she did not. But this is not of special importance since the refund should have been allowed in either event.

The transfer of October 1st, 1917, was not made in contemplation of death within the legal significance of those words. It was not testamentary in character and was beyond recall by the decedent. At the death of Mrs. May no interest in the property held under the trust deed passed from her to the living; title thereto had been definitely fixed by the trust deed. The interest therein which she possessed immediately prior to her death was obliterated by that event. . . .

The judgment of the Circuit Court of Appeals is erroneous and must be reversed. The cause will be remanded to the District Court for further proceedings in conformity with this opinion.

Reversed.

The Events of 1931–1932 and Their Immediate Sequel

Although it would seem that the reserved life estate was the one situation which Congress most clearly intended to cover by the statute, the decision in *May v. Heiner* gave a clear indication which way the wind was blowing. The case is a rather unusual one, because of the double life estate, and it is curious that the Government risked the question on such facts.

The Treasury then brought forward three cases directly involving the reserved life estate situation. "The Treasury" is used advisedly, because the Department of Justice, while allowing the cases to be taken to the Supreme Court, did not support the Government's position there, believing that the question had been foreclosed by *May v. Heiner.*

These cases involving reserved life estates were argued on February 27, 1931. On the following Monday, March 2, 1931, they were all decided in identical per curiam opinions, of which the following is one:

BURNET v. NORTHERN TRUST CO.

Supreme Court of the United States, 1931. 283 U.S. 782.

PER CURIAM. The question in this case is that of the construction of section 402(c) of the Revenue Act of 1921, c. 136, 42 Stat. 227, 278, a provision similar to that of section 402(c) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1097, which has already been construed by this Court, and, in this view, there being no question of the constitutional authority of the Congress to impose prospectively a tax with respect to transfers or trusts of the sort here involved, the judgment of the United States Circuit Court of Appeals for the Seventh Circuit (41 F.2d 732) is affirmed upon the authority of *May v. Heiner,* 281 U.S. 238.

The other cases so decided were *Morsman v. Commissioner*, 283 U.S. 783 (1931), and *McCormick v. Burnet*, 283 U.S. 784 (1931).

These cases were decided on March 2, 1931. Less than two days remained before Congress adjourned on March 4, 1931. But a bill amending the provision which became section 811(c) of the 1939 Code was drafted overnight, presented to Congress on the morning of March 3, 1931, considered by the Ways and Means Committee, passed by the House, considered by the Finance Committee, passed by the Senate, and signed by the President that evening. This was the Joint Resolution of March 3, 1931, c. 454, 46 Stat. 1516. It made it clear that a transfer with life estate reserved was taxable.

The language of the Joint Resolution was amended in some matters of detail by the Revenue Act of 1932, which became law on June 6, 1932. As so amended this is the provision which is now found in substance in sec. 2036(a) of the 1954 Code.

In due course, two cases came before the Supreme Court involving these provisions of 1931–1932.

(1) *Prospective validity.* In *Helvering v. Bullard*, 303 U.S. 297 (1938), the Court upheld the constitutionality of the Joint Resolution of March 3, 1931, as applied to a trust created on February 17, 1932, with a life estate reserved. The decedent died in 1933. It may seem difficult now to see how the constitutional validity of this provision, prospectively applied, could be seriously questioned. The argument was that the transfer to the remainderman was made by the inter vivos gift, not by the death, and that there was accordingly nothing happening at death which could be the proper subject of a tax. The Court disposed of the argument without difficulty, saying: "Since Congress may lay an excise upon gifts it is of no significance that the exaction is denominated an estate tax or is found in a statute purporting to levy an estate tax. Moreover, Congress having the right to classify gifts of different sorts might impose an excise at one rate upon a gift without reservation of a life estate and at another rate upon a gift with such reservation. Such a classification would not be arbitrary or unreasonable."

Thus it has long been clear that all reserved life estates created after March 3, 1931, are subject to an estate tax on the death of the transferor.

(2) *Non-retroactive application.* On the same day, the Court decided *Hassett v. Welch*, 303 U.S. 303 (1938). This involved a transfer made in 1924, reserving a life estate, where the transferor died in November, 1932. The Court, examining the background and the legislative history, together with substantially contemporaneous construction by the Treasury (found in T.D. 4314, X–1 Cum.Bull. 450 (1931)), held that the legislation of

1931 and 1932 was not to be construed to apply to transfers which had been irrevocably made before March 3, 1931.

On this basis, the law in this area seemed to be quite well established, with March 3, 1931, the critical dividing point.

The Church case

In 1949, the relative though somewhat illogical calm of this situation was upset by a decision of the Supreme Court in *Commissioner v. Estate of Church,* 335 U.S. 632 (1949). This case involved a trust created in 1924, with a life estate reserved. The transferor died in 1939. The Court held that the property was taxable in the transferor's estate. In reaching this conclusion it held that *May v. Heiner* "can not longer be accepted as correct." It then held that the reserved life estate was taxable under the "general language" of sec. 811(c), which had been in effect since 1916. Thus the decision in *Hassett v. Welch* that the Joint Resolution of March 3, 1931, should not be construed to have retroactive effect became immaterial, since the language added to the statute by the Joint Resolution was not relied on to support the tax. Vigorous dissents were registered by Justices Reed, Frankfurter and Burton.[1]

Under the *Church* decision all reserved life estates became taxable no matter when created, at least if they were established after the first estate tax was enacted in 1916.

The immediate consequence of this decision was action by Congress, which began with the Technical Changes Act of 1949, and continued with several subsequent amendments. It is not necessary here to follow these through in detail. Their net effect is now found in sec. 2036(b) of the 1954 Code. It will be seen that this restores the law as it was prior to the *Church* decision. Reserved life estates created before March 4, 1931, are not taxable. Those created after March 3, 1931, are taxable, with a small exception for those created between March 3, 1931, and before June 7, 1932, which were not within the 1931 statute. For all practical purposes, we may say that the cut-off date for retained life estates is March 3, 1931. The *Church* case and its complicated statutory aftermath become simply an episode, leaving no permanent change in the law.[2]

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1 For discussion, see Bittker, "The Church and Spiegel Cases: Section 811(c) Gets a New Lease on Life," 58 Yale L.J. 825 (1949).

2 For a discussion of the statutory provisions which in effect overruled the Church case, see Bittker, "Church and Spiegel: The Legislative Sequel," 59 Yale L.J. 395 (1950); Pavenstedt, "Congress Deactivates Another Bombshell: The Mitigation of Church and Spiegel," 5 Tax L.Rev. 309 (1950).

McNICHOL'S ESTATE v. COMMISSIONER

United States Court of Appeals, Third Circuit, 1959. 265 F.2d 667.
Certiorari denied 361 U.S. 829 (1959).

STEEL, DISTRICT JUDGE. More than nine years before his death, the decedent purported to convey certain income-producing real estate to his children. Thereafter, pursuant to an oral understanding with his children, the decedent continued to receive the rents from the properties until his death. The Tax Court held that the properties were includable in the decedent's gross estate under § 811(c)(1)(B) of the I.R.C. of 1939. [Corresponding to sec. 2036 of the 1954 Code. Ed.] 29 T.C. 1179. That decision is before us for review.

The following findings by the Tax Court are supported by the record and are accepted as a basis for our decision:

Between 1939 and 1942 the decedent, a Pennsylvania resident, executed general warranty deeds to his children for income-producing real estate, together with the rentals therefrom, which he owned in Pennsylvania. The deeds were recorded. They reserved no interest in the realty or rents to the decedent, and the decedent received no consideration in connection with the transaction. Following the execution of the last deed the grantees, as owners-landlords entitled to the rental income, registered the properties with the O.P.A.

Contemporaneously with and subsequent to the execution of the deeds, it was orally understood between the decedent and his children that the decedent should retain for his lifetime the income from the real estate. In accordance with this understanding the decedent actually received all of such income from the dates of the deeds to the time of his death.

In his federal income tax returns for 1948 to 1950, inclusive, and for the period from January 1, 1951 to the time of his death on June 17, 1951, the decedent reported the rents as his personal income.[2] In the same returns the decedent claimed as deductions depreciation, taxes and water rent applicable to the properties.

The petitioners contended before the Tax Court that under Pennsylvania law the deeds conferred upon the children a fee simple title, that the Pennsylvania statute of frauds barred the grantor from enforcing his oral understanding against his children, and that the grantor therefore had retained no "right" to the income "under" the transfer within the meaning of the statute. The Tax Court rejected this argument and held that Pennsylvania law was immaterial, and that the test of gross estate includability under § 811(c)(1)(B) was a factual one; i. e.,

[2] The record fails to reveal how the rents were treated in prior periods.

whether a decedent in reality had retained possession or enjoyment of the property. Finding that the collection of the rents by decedent pursuant to his understanding with his children constituted a factual enjoyment of the properties under the transfer, the Tax Court held that the properties were properly included in decedent's gross estate.

Petitioners argue that § 811(c)(1)(B) is inapplicable to a transfer with a retained income interest unless that interest is reserved in the instrument of transfer. This argument is based upon the statutory provision that the income must be retained "*under*" the transfer. This is too constricted an interpretation to place on the statute. The statute means only that the life interest must be retained in connection with or as an incident to the transfer. . . .

Next, petitioners point out that the statute speaks of the retention of "the right to the income". Emphasizing the word "right", petitioners argue that Congress has decreed that § 811(c)(1)(B) is applicable only if a transferor reserves to himself an enforceable claim to the income. Since, according to petitioners, the statute of frauds of Pennsylvania would foreclose judicial enforcement of the oral understanding between the decedent and his children, petitioners conclude that the decedent had no "right" to the income from the property.[3]

It is not necessary for us to delve into Pennsylvania law, for the question is not one of local law. Rather, it is whether Congress intended that § 811(c)(1)(B) should subject to an estate tax property conveyed under circumstances which here prevail. While state law creates legal interests and rights, it is the federal law which designates which of these interests and rights shall be taxed. *Morgan v. Commissioner,* 1940, 309 U.S. 78, 80–81; *Helvering v. Stuart,* 1942, 317 U.S. 154, 162.

In seeking to discover the type of transfers at which § 811(c)(1)(B) is aimed, the words "right to the income" are not entitled to undue emphasis. Section 811(c)(1)(B) states that property which has been transferred *inter vivos* is includable in the gross estate of a decedent when the decedent "has retained for his life * * * the possession or enjoyment of, or the right to the income from the property * * *". Thus, the statute deals with two things: retention of "possession or enjoyment" and retention of "the right to the income".

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[3] The law of Pennsylvania seems not to be as unqualified as petitioners state. If the decedent's children had refused to honor their oral agreement and had collected the rent themselves, the statute of frauds would not have barred the decedent from recovering the rents from the children if, as in the case at bar, they admitted the existence of the oral agreement. Under the circumstances hypothesized decedent would have had an enforceable claim against his children. Metzger v. Metzger, 1940, 338 Pa. 564, 14 A.2d 285, 129 A.L.R. 683; Kauffman v. Kauffman, 1920, 266 Pa. 270, 109 A. 640.

The history of the statute discloses that "the right to the income" clause was not intended to limit the scope of the "possession or enjoyment" clause used in § 811(c)(1)(B). Section 811(c)(1)(B) derives directly from § 302(c) of the Act of 1926, as amended in 1931, and 1932. The amendment of 1931 included for the first time express language taxing property which had been transferred *inter vivos* with a lifetime retention of "the possession or enjoyment of, or the income from" the property. This amendment said nothing about the "right to" income. The words "right to" were inserted for the first time by the 1932 amendment, and the language of the 1932 amendment was carried over into § 811(c) of the I.R.C. of 1939. This insertion was to make clear that Congress intended that the statute should apply to cases where a decedent was entitled to income even though he did not actually receive it. H.R.Rep. No. 708, 72d Cong.; 1st Sess. pp. 46–7 (C.B. 1939–1, Part 2, pp. 490–1); Sen.Rep.No. 665, 72d Cong.; 1st Sess. pp. 49–50 (C.B. 1939–1, Part 2, p. 532).[5] Hence, the "right to income" clause, instead of circumscribing the "possession or enjoyment" clause in its application to retained income, broadened its sweep.

The conclusion is irresistible that the petitioners' decedent "enjoyed" the properties until he died. If, as was said in *Commissioner v. Estate of Church,* supra, 335 U.S. at page 645, the most valuable property attribute of stocks is their income, it is no less true that one of the most valuable incidents of income-producing real estate is the rent which it yields. He who receives the rent in fact enjoys the property. Enjoyment as used in the death tax statute is not a term of art, but is synonymous with substantial present economic benefit. *Commissioner v. Estate of Holmes,* 1945, 326 U.S. 480, 486. Under this realistic point of view the enjoyment of the properties which the decedent conveyed to his children was continued in decedent by prearrangement and ended only when he died. The transfers were clearly of a kind which Congress intended that § 811(c)(1)(B) should reach.

This conclusion, petitioners insist, is irreconcilable with the decisions in *Nichols v. Coolidge,* 1927, 274 U.S. 531, and in *Burr's Estate,* 4 T.C.M. 1289 (1945), *Scheide's Estate,* 6 T.C.M. 1271 (1947), and *Richards' Estate,* 1953, 20 T.C. 904. The cited Tax Court decisions may be dispatched summarily. In none of them did it appear, as it does in the case at bar, that the transferor

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5 In referring to the changes made by the 1932 Act to the Joint Resolution of March 3, 1931, H.R.Rep. No. 708 states:

"(3) The insertion of the words 'the right to the income' in place of the words 'the income' is designed to reach a case where decedent had the right to the income, though he did not actually receive it. This is also a clarifying change."

Sen.Rep. No. 665 says the same thing.

retained the income from the transferred property by virtue of an understanding between the transferor and transferee at the time of the transfer.[6]

Nichols v. Coolidge, supra, however, may not be so readily disposed of. There, the grantor without consideration had conveyed the fee of her residences to her children, with a contemporaneous lease back for a nominal consideration. It was understood that the lease would be renewed so long as the grantor desired. Four years later the grantor died. The Commissioner included the realty in the decedent's gross estate under § 402 of the Act of 1919, 40 Stat. 1097 on the ground that the transfer was "intended to take effect in possession or enjoyment at or after his death". The District Court held that the Commissioner's action was unauthorized. It reasoned that the grantor had no "valid agreement" for the renewal of the lease, that the conveyance gave the grantees full possession and enjoyment of the properties, and that the transaction vested in the grantees "complete title". The Supreme Court affirmed upon the basis of the District Court decision.

The present-day importance of *Nichols v. Coolidge* can be understood only when it is viewed in its historical setting. The statute under which it was decided provided that property transferred *inter vivos* should be included in the gross estate of a decedent when the transfer was [274 U.S. 531]

> " * * * in contemplation of or intended to take effect in possession or enjoyment at or after his death."

Interpreting this same statutory language four years later, the Court held in *May v. Heiner,* 1930, 281 U.S. 238, that property which had been irrevocably transferred under a formal agreement of trust reserving to the settlor an interest in the income terminable at his death was not includable in the gross estate of the settlor since the title had vested in the transferee at the time of transfer. Although *May v. Heiner* made no reference to *Nichols v. Coolidge,* both decisions turned upon the fact that legal title had been technically transferred prior to death, and hence the transfer was not "intended to take effect in possession or enjoyment at or after his death". [281 U.S. 238] This dispositive principle was reaffirmed on March 2, 1931 in *Burnet v. Northern Trust Co.,* 1931, 283 U.S. 782; *Morsman v. Burnet,* 1931, 283 U.S. 783, and *McCormick v. Burnet,* 1931, 283 U.S. 784, by *per curiam* decisions based upon *May v. Heiner.* These decisions upset the long-standing Treasury interpretation of the "in-

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6 We intimate no opinion as to whether we would have followed these decisions if, in the case before us, the decedent had received the rents following the transfer without an agreement with his children that he might do so.

tended to take effect in possession or enjoyment" clause which had been in the Revenue Act since 1916, 39 Stat. 777.

The following day Congress, in order to close the obvious tax loophole which the decisions had opened, adopted the Joint Resolution of March 3, 1931. This resolution redefined the phrase "intended to take effect in possession and enjoyment at or after his death" so that it would include a transfer under which the transferor "retained for his life * * * the possession or enjoyment of, or the income from" the transferred property. This provision and its substantial embodiment in later amendments to the Revenue Act made taxable property which had been transferred *inter vivos* under a formal declaration of trust with a life estate reserved to the settlor. That was its purpose. By this resolution Congress rejected the view of *May v. Heiner* and its progeny that estate tax includability depended upon whether or not title had technically passed. Cf. *Hassett v. Welch,* 1938, 303 U.S. 303, 309–310. The premise of *Nichols v. Coolidge* was precisely the same as that of *May v. Heiner;* hence, the effect of the Joint Resolution was to undo *Nichols v. Coolidge* as well. Since Congress barred resort to formal trust agreements with reserved life estates as a means of circumventing the payment of death taxes, it is unreasonable to conclude that it intended to permit the accomplishment of the same result by an oral agreement having an identical effect. . . .

What we have said finds substantiation in the basic philosophy of *Commissioner v. Estate of Church,* supra, which expressly repudiated *May v. Heiner.* The Church opinion emphasizes that the criterion for determining whether property transferred *inter vivos* is subject to a death tax is the effect of the transfer, and states that whenever in fact the ultimate possession or enjoyment of property is held in suspense until the death of the transferor, the property is swept into the decedent's gross estate by the statute. Substance and not form is made the touchstone of taxability. The Court holds that an estate tax cannot be avoided by a gift unless it is (335 U.S. at page 645):

> "* * * a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. * * "

It is true that the Church opinion refers to "a property right" in the income, "the right to the income", the "right to possess or to enjoy the property" and other expressions which may be pointed to as imputing legal collectability of the income. The Church language was, of course, patterned to fit the situation with which the Court was dealing, i. e., a transfer of property under a formal trust agreement in which the trustor retained an enforceable right to the income. But as we read the decision

its bite goes deeper; and the opinion constitutes a sweeping and forthright declaration that technical concepts pertaining to the law of conveyancing cannot be used as a shield against the impact of death taxes when in fact possession or enjoyment of the property by the transferor—and more particularly his enjoyment of the income from the property—ceases only with his death.

Section 7(b) of the Technical Changes Act of 1949, 63 Stat. 895, 26 U.S.C.A. § 811 note, did not impugn the basic soundness of the Church concept of "possession and enjoyment". While it nullified the prospective effect of the Church decision in its application to transfers antedating the Joint Resolution of 1931, this simply reflected Congressional solicitude for taxpayers who, in reliance upon *May v. Heiner,* had refrained from divesting themselves of life estates reserved under trusts created prior to the Joint Resolution of 1931. See Sen.Rep. No. 831, 2 U.S.C. & Cong.Serv., 81st Cong., 1st Sess. 1949, pp. 2172, 2180. Since the transfers at bar were effected between 1939 and 1942 the *rationale* of the Church case is directly apposite.

The decision of the Tax Court will be affirmed.

Notes

(A) Suppose the reservation is express, but is a little more subtle, involving a fixed payment rather than the income *from* the property itself.

In *Lincoln v. United States,* 65 Ct.Cls. 198 (1928), it appeared that a woman ~~conveyed property~~ worth $125,000 to her son and daughter, and they agreed to pay her $6,000 a year as long as she lived. The son and daughter also agreed to pay the taxes on the property, up to $1,500 a year, and to hold the property as joint tenants until the mother died. The court held that this was a bona fide sale of the property, and that nothing was to be included in the mother's gross estate on account of it.

With this decision should be compared *Estate of Cornelia B. Schwartz,* 9 T.C. 229 (1947). There a woman aged 86 transferred substantially all of her property to her children in return for their promise to pay her $7,000 a year for the rest of her life. This was the estimated annual income that the property would yield. The children at the same time transferred the property to a trust company upon trust to pay $7,000 a year to the mother for life with any excess income to be paid to a daughter. The property did not yield $7,000 per annum and the children made no attempt to make up the difference. The decedent died twelve years later. The Court held that the decedent had retained the "possession or enjoyment of or right to the income from the property," and that its value was includible in her gross estate.

Transactions of this type might be divided into two categories: (1) Where the transferor reserves no interest in the property but has a purely contractual right to payments from the transferee; (2) where the transferor retains a security interest in the prop-

erty to secure the transferee's contractual obligation to pay. The *Lincoln* case holds the second type to be outside the statute. Query, is this the place to draw the line? *Cf. Tips v. Bass,* 21 F.2d 460 (W.D.Tex.1927), where a tax was imposed.

(B) In *Estate of George L. Shearer,* 17 T.C. 304 (1951), it appeared that T transferred a farm to a corporation of which he owned all the stock, and leased the farm back for $1 a year. Over a period of several years he gave 190 shares of stock in the corporation (out of a total of 250 shares) to his two daughters, retaining the remaining 60 shares. Shortly after the final transfer of stock, the corporation was dissolved. In the dissolution, the farm was conveyed to T for life, with remainder to his two daughters as tenants in common. At the time the value of his life estate received was approximately the same as the value of his 60 shares of stock.

The Tax Court held that the entire value of the farm was includible in T's gross estate, as a transfer with life estate reserved.

(C) A man created a trust with the provision that the income should be paid to his wife for her "support and maintenance." The remainder was payable to their children. The court held that since the income "was, in the language of the regulations, 'to be applied towards the discharge of a legal obligation of the decedent,'" he had "retained the enjoyment of that income," and the value of the trust property was includible in his gross estate. *Commissioner v. Dwight's Estate,* 205 F.2d 298 (C.A.2d, 1954); *Estate of William H. Lee,* 33 T.C. — (1960). Compare the income tax cases at pp. 275–276, 284(G), above.

(D) A woman, aged 76, took out life insurance policies and annuity policies at the same time. Because of her age the insurance company would not have sold the life insurance policies to her unless she bought the annuities, too. In the same year she irrevocably gave the insurance policies to her children, and a gift tax was paid on this transfer. She retained the annuities until her death about ten years later. The government sought to tax the life insurance on the basis that she had made a transfer of property on which she had retained "the right to the income" within what is now sec. 2036(a) of the 1954 Code. The Supreme Court held no tax was due. The annuity policies were separate, and "the annuity payments arose solely from the annuity policies." The decedent had not "retained income from the life insurance contracts"—which alone were transferred. *Fidelity-Philadelphia Trust Co. v. Smith,* 356 U.S. 274 (1958).

(E) Suppose a person transfers property, reserving a life estate. Thereafter he conveys away his life estate either (a) by gift or (b) for full and adequate consideration. The transfer is not made in contemplation of death. Thereafter he dies. (1) Is the property to be included in his gross estate? (2) Suppose the same facts, except that the conveyance of the life estate is made in contemplation of death. Is the property included in his gross estate? If the answer to the first question is "no," and the answer to the second question is "yes," how can this be worked out under the actual wording of the statute? In these cases, the original conveyance remains within the terms of the statute. The decedent has made the sort of transfer to which the statute

refers. Should the statute be construed to require not only a transfer of the sort designated, but also the persistence of such a transfer?

The Treasury has ruled that where the transfer of the life estate in this situation is made in contemplation of death, the entire value of the property is taxable. Rev.Rul. 56–324, 1956–2 Cum.Bull. 999. See, dealing with these questions under a state inheritance tax law, *In re Thurston's Estate,* 36 Cal.2d 207, 223 P.2d 12 (1950). See also *Estate of Charles J. Miller,* 40 B.T.A. 138 (1939).

STATE STREET TRUST CO. v. UNITED STATES

United States Court of Appeals, First Circuit, 1959. 263 F.2d 635.

WOODBURY, CIRCUIT JUDGE. . . . The problem on this appeal arises from the provisions of the third paragraph of the trusts wherein the trustees are clothed with broad powers with respect to the investments open to them and their management of the assets of the trusts. The language of this paragraph which the court below found to be so broad that the trustees were not limited in the exercise of their fiduciary duties by any determinable standard, so that the rule of the Jennings case does not apply to prevent inclusion of the corpora of the trusts in the deceased settlor's gross estate, and on which the government relies to sustain that holding, is as follows:

> "In addition to and not in limitation of all common law and statutory authority, the Trustees shall have power * * * to exchange property for other property; * * * to retain and invest and reinvest in securities or properties although of a kind or in an amount which ordinarily would not be considered suitable for a trust investment, including, but without restriction, investments that yield a high rate of income or no income at all and wasting investments, intending hereby to authorize the Trustees to act in such manner as it is believed by them to be for the best interests of the Trust Fund, regarding it as a whole, even though particular investments might not otherwise be proper; * * * to determine what shall be charged or credited to income and what to principal notwithstanding any determination by the courts and specifically, but without limitation, to make such determination in regard to stock and cash dividends, rights, and all other receipts in respect of the ownership of stock and to decide whether or not to make deductions from income for depreciation, amortization or waste and in what amount; * * * and generally to do all things in relation to the Trust Fund which I, the Donor, could do if living and the Trust had not been executed."

In conclusion the third paragraph of the trust provides: "All such acts and decisions made by the Trustees in good faith shall

be conclusive on all parties at interest and my Trustees shall be liable only for their own wilful acts or defaults, but in no case for acts in error of judgment."

The case is very close, but we agree with the result reached by the District Court.

It is true that it is not at all unusual to clothe trustees with power to invest trust assets in securities other than so-called "legals." And it is also true that it is far from uncommon to provide that trustees shall have the power in their discretion to allocate accretions to the property they hold in trust to principal or to income, at least when there is no settled rule of law to apply and proper allocation is open to honest doubt. Certainly in the exercise of one or both of these powers trustees can to some extent affect the interests of the various beneficiaries. Indeed, even in a trust wherein investment is limited to "legals," a trustee can effect some shifting of benefits between life beneficiaries and remaindermen by his choice of investment with respect to rate of income return or growth potential. But we would hardly suppose that in the ordinary case inclusion of one or both of the above provisions in a trust instrument would be a crucial factor in deciding whether or not the corpus of the trust should be included in a decedent's estate.

This, however, is not an ordinary case. Literally, the trustees have power to exchange trust property for other property without reference to the value of the properties involved in the exchange. And literally, they have power to invest the trust assets in securities yielding either a high rate of income or no income at all, and even in wasting investments, and they have power to invest trust assets in these categories in whatever amounts they choose without limitation with respect to the percentage of the trust corpus invested in any one of them. Moreover, the trustees' discretionary power to allocate trust assets to corpus or income is not limited to situations where the law is unsettled and there is honest doubt whether a given accretion or receipt should be classified as capital or income. See *Doty v. Commissioner,* 1 Cir., 1945, 148 F.2d 503, 507, and Scott on Trusts §§ 232–237 (2d ed. 1956). Indeed the trustees' power of allocation does not seem even to be limited to accretions or receipts but would appear to extend in terms to any item of trust property. Furthermore, the trustees may make deductions from income for depreciation, amortization or waste in whatever amounts they see fit. They are, to be sure, required to exercise good faith in their dealings with the trust properties and furthermore they are admonished "to act in such manner as it is believed by them to be for the best interests of the Trust Fund, regarded as a whole." But they are immune from liability for errors of judgment however gross; their only stated liability is "for their own wilful acts or defaults."

In spite of the breadth of the language used, we do not conceive, however, that short of "wilful acts or defaults," the trustees are as free as the wind in their administration and management of the trusts. As stated by Judge Learned Hand in *Stix v. Commissioner*, 2 Cir., 1945, 152 F.2d 562, 563: "* * * no language, however strong, will entirely remove any power held in trust from the reach of a court of equity. After allowance has been made for every possible factor which could rationally enter into the trustee's decision, if it appears that he has utterly disregarded the interests of the beneficiary, the court will intervene. Indeed, were that not true, the power would not be held in trust at all; the language would be no more than a precatory admonition."

We may therefore assume that a Massachusetts court of equity at the behest of a beneficiary would intervene not only in the event of a wilful act or default by the trustees, but would also intervene in the event the trustees should act in utter disregard of the rights of a beneficiary. Thus, no doubt, an appropriate court of the Commonwealth in the exercise of its equity jurisdiction would prevent the trustees from putting all, or nearly all, of the trust assets in wasting investments bearing a high rate of income for the benefit of a life tenant at the expense of a remainderman. And no doubt, also, the court would step in to prevent the investment of all, or nearly all, the trust assets in a property yielding little or even no income for the benefit of a remainderman at the expense of a life beneficiary. But short of utter disregard of the rights of a life tenant or a remainderman springing from "arbitrary or dishonest conduct or bad faith, or fraud" *Dumaine v. Dumaine,* 1938, 301 Mass. 214, 224, 16 N.E.2d 625, 630, 118 A.L.R. 834, a Massachusetts court would have no external standard with which to measure the trustees' conduct. The area of the trustees' discretion, although not untrammelled, is about as broad as language can make it and the law permits, and within that area the trustees can act in the administration and management of their trusts to confer or withhold very substantial benefits as between the life tenants and remaindermen.

Perhaps no single power conferred by the decedent on the trustees would be enough to warrant inclusion of the corpora of the trusts in his estate. But we believe that the powers conferred on the trustees, considered as a whole, are so broad and all inclusive that within any limits a Massachusetts court of equity could rationally impose, the trustees, within the scope of their discretionary powers, could very substantially shift the economic benefits of the trusts between the life tenants and the remaindermen. We therefore conclude that under the trusts the decedent as long as he lived, in substance and effect and in a very real sense, in the language of § 811(c)(B)(ii), "retained for his

life * * * the right * * * to designate the persons who shall possess or enjoy the property or the income therefrom; * * * "

Since we believe that the corpora of the trusts is includible in the decedent's gross estate under § 811(c) there is no need for us to consider the impact, if any, of § 811(d).

A decree will be entered affirming the judgment of the District Court.[1]

Note

See Gray and Covey, "State Street—A Case Study of Sections 2036(a) (2) and 2038," 15 Tax L.Rev. 75 (1959). There is a comment on the *State Street* case in 45 Iowa L.Rev. 426 (1960).

Who is the Settlor of a Trust

Ordinarily, the person who transfers property on trust will be the settlor or grantor of a trust. But this is not necessarily true, for tax purposes, at least. For example A might pay B to create a trust. Though B signed the trust instrument, and transferred the property to a trustee, A would be the grantor or settlor of the trust. Consider the case where a person having power to terminate a trust, terminates it in favor of a beneficiary but only on condition that he transfer the property on a new trust. See *State Street Trust Co. v. United States*, 263 F.2d 635, 637 (C.A. 1st, 1959). *Cf. Buhl v. Kavanagh,* 118 F.2d 315 (C.C.A.6th, 1941), an income tax case. See also *Estate of George W. Sweeney,* 4 T.C. 265 (1944), aff'd, 152 F.2d 102 (C.C.A.2d 1945); *Farmers and Merchants Bank v. United States,* 125 F.Supp. 587 (S.D.Cal.1954).

In *National Bank of Commerce v. Clauson,* 226 F.2d 446 (C.A. 1st, 1955), it appeared that a wife released her claim to take one-third of her husband's property against his will. In exchange for this, an inter vivos trust was created for her and her two stepchildren. It was held that she was the settlor as to one-third of this trust, and that this amount was includable in her gross estate.

McLAIN v. JARECKI

United States Court of Appeals, Seventh Circuit, 1956. 232 F.2d 211.

FINNEGAN, CIRCUIT JUDGE. As crystallized by the district judge and the parties to this appeal, the question here is whether "reciprocal" or "crossed" trusts are established by the stipulated facts incorporated in findings of fact reported below as *McLain v. Jarecki,* D.C.N.D.Ill.1955, 126 F.Supp. 621.

Appealing from a judgment adverse to it, in favor of plaintiff for $56,983.91, the government asks us to distinguish the current case from *Newberry's Estate v. Commissioner,* 3 Cir., 1953,

1 A dissenting opinion by Chief Judge Magruder is omitted.

201 F.2d 874, 38 A.L.R.2d 514 and apply *Lehman v. Commissioner*, 2 Cir., 1940, 109 F.2d 99, which the district judge refused to follow. We also decline to do so.

We are not called upon to construe or interpret any provisions contained in the trusts involved here. Consequently it is unnecessary to reproduce these parts of the stipulated facts. In any event the gist of each trust is clearly and cogently stated in the district court's reported opinion, 126 F.Supp. 621, 622, 623, where through stipulated facts that court described the creation of two separate trusts on December 27, 1934; one by Albert O. McLain, the husband, and the other by Minnie A. McLain, his wife; the similar provisions of the two trusts; and the amendment of both trusts on December 18, 1935.

The trust created by the husband, referred to as the Dorothy trust, provided that the net income of the trust was to be accumulated and added to the principal of the trust until the death of Albert O. McLain, the grantor. After his death the income was to be paid to his wife during her lifetime and after the death of both Albert O. McLain and Minnie A. McLain, the income was to be paid to Dorothy McLain Cole, their daughter, or to her issue. The Dorothy Trust also provided that it could be revoked during the lifetime of the grantor while either Minnie A. McLain or Harold O. McLain, their son, was living, by an instrument in writing signed by Minnie A. McLain, Harold O. McLain and Dorothy McLain Cole, or such of them as were then living, and by all persons affected thereby. As amended in 1935 the Dorothy Trust was modified to permit Harold O. McLain and Minnie A. McLain to terminate the trust during the lifetime of Dorothy McLain Cole or any of her issue. If so terminated, the trust estate was to be distributed to Dorothy McLain Cole, if living, or if she were not living, then to her issue.

The trust created by Minnie A. McLain, the wife, contained similar conditions providing for the accumulation of the income during her lifetime, thereafter payment of the income to her husband, and finally termination and distribution to their son, Harold O. McLain, or his issue.

The doctrine, if it can rightly be called one, of "reciprocal" or "crossed" trusts is a judicial concept [*Estate of Louise De Witt Ruxton v. Commissioner*, 20 T.C. 487, 494 (1953)] invoked when measuring certain trusts by § 811(c)(1)(B) of the Internal Revenue Code of 1939. Specifically the problem before us is whether federal estate taxes were erroneously assessed and collected upon the corpus of a trust created by the decedent's wife, Minnie McLain, construed, by the government's Collector, as being includible in the decedent husband's gross estate by operation of § 811(c)(1)(B) and (d)(2) of the Code.

Lehman v. Commissioner, 2 Cir., 1940, 109 F.2d 99, was decided upon facts stipulated at the Board of Tax Appeals level. 1939, 39 B.T.A. 17, 19–20. *McLain v. Jarecki,* D.C.N.D.Ill.1955, 126 F.Supp. 621, 624, contains an adequate analysis of the Lehman facts, to which we would add this line from the Second Circuit's opinion, 109 F.2d 99, 100: "The fact that the trusts were reciprocated or 'crossed' is a trifle, quite lacking in practical or legal significance. * * *" But the clue to Lehman lies in the line: "While section 302(d) [under the 1926 Act] speaks of a decedent having made a transfer of property with enjoyment subject to change by exercise of power to alter, amend or revoke in the decedent, it clearly covers a case where the decedent by paying a *quid pro quo* has caused another to make a transfer of property with enjoyment subject to change by exercise of such power * * *." 109 F.2d 99, 100. The short of Lehman is that a person becomes the settlor of a trust if he supplies the consideration, in spite of another person's mechanical declaration of the trust. Hence the Lehman court searched for consideration moving from the decedent to his brother, and having found it affirmed the Board's decision holding the trusts includible in decedent's estate.

But among the stipulated facts submitted to us, we find none expressly showing that Albert O. McLain, decedent here, brought about the transfer from his wife, Minnie A. McLain. Because the McLains had substantially identical trusts created concurrently and prepared by their mutual lawyers, the government would have us infer an element of consideration from which to hold that decedent was the actual grantor of the trust in which his wife declared herself to be the grantor. From that argument of course, it would follow that the corpus of the wife's trust would be includible in decedent's gross estate by force of § 811(c)(1)(B) and (d)(2). Both McLains are deceased. Without any oral testimony taken below the usual matter of witnesses' credibility and demeanor evidence is similarly absent here. To reach the inference, indispensable for the government's position, would mean compounding probabilities on the subjective impression we have of the objective stipulated facts. Unlike interpreting written instruments, the government insists upon locating some subjective understanding between the parties that will equate to *quid pro quo.* But we are, here, relating a situation remote in time and deficient in complete manifestation to § 811. These trusts, and the stipulated facts can also be read as articulating a donative state of mind once extant between the McLains, *Newberry's Estate v. Commissioner,* 3 Cir., 1953, 201 F.2d 874; *Estate of Louise De Witt Ruxton v. Commissioner,* 1953, 20 T.C. 487. The district judge's ultimate find-

ing. 126 F.Supp. 621, 625, will stand undisturbed. *Chicago Title and Trust Co. v. United States,* 7 Cir., 1954, 209 F.2d 773, 775.

. . .

Judgment affirmed and case remanded.

SCHNACKENBERG, CIRCUIT JUDGE (dissenting). Defendant relies on *Lehman v. Commissioner of Internal Revenue,* 2 Cir., 109 F.2d 99, while plaintiff relies on *Newberry's Estate v. Commissioner of Internal Revenue,* 3 Cir., 201 F.2d 874.

In the *Lehman* case the existence of consideration was uncontroverted. There, two brothers owned equal shares in stocks and bonds. Harold agreed to transfer his share in trust for Allen and his issue, in consideration of Allen transferring his share in trust for Harold and his issue. The trust instruments were duly executed and each brother thereby granted to the other, in the trust created, the income for the other's life, with remainder to the latter's issue, together with a right in the other to withdraw $150,000 from the principal.

In the *Newberry* case, where the court, based upon oral testimony, held there was no consideration, Mr. and Mrs. Newberry each executed a trust conveying his or her own property for the benefit of their children. However, neither settlor created any beneficial interest therein for his or her spouse.

In the case at bar there is no parole evidence in the record. We have merely the instruments creating the trusts and amending them. At the time and place when and where Albert executed a trust creating *inter alia* a life estate for the benefit of his wife Minnie, she executed precisely the same form of trust covering precisely the same amount and kind of property, thereby creating *inter alia* a similar life estate for the benefit of Albert. The two trusts together also provided for their children and their families. Here is a beneficial interest contemporaneously bestowed upon the maker of each trust, by the maker of the other trust. The significance of this circumstance has been overlooked by the majority opinion. It is an undue taxing of our credulity to ask us to believe that this transaction lacked consideration. The only logical inference to be drawn from the stipulated facts is that, when Albert gave to Minnie a life estate in a trust which he then created, and she contemporaneously did the same for him, the act of one was the consideration for the act of the other. In an exchange the property received is consideration for the property given. *Cole's Estate v. Commissioner of Internal Revenue,* 8 Cir., 140 F.2d 636, at page 637. Both reason and the law place upon him who would rebut this reasonable inference the burden of introducing evidence to that end. The competent attorneys who devised the plan now reviewed before us and their assistants or office associates were certainly in a

position to introduce evidence on this subject, the nature of which is exemplified in the *Newberry* case. However, it is well to point out that even such testimony, to be effective, must counterbalance the fact of the execution of the trust agreements and their contents. In the case at bar, such evidence would have to explain why each of the trusts set up a life estate in the spouse of the maker of the trust. *Orvis v. Higgins,* 2 Cir., 180 F.2d 537, at page 540.

In the instant case Albert, in consideration of granting to Minnie, in the Dorothy trust which he set up, the possession and enjoyment of and right to the income from his trust estate, during her lifetime, procured from her a similar life estate in the Harold trust, which she set up. Under § 811(c)(1)(B) the Harold trust created by Minnie must be treated as though created by decedent, and thereby § 811(c)(1)(B) operates to bring the corpus of that trust into Albert's gross estate.[1] . . .

Accordingly, I would reverse the district court.

Notes

(A) For some time *Lehman v. Commissioner,* 109 F.2d 99 (C.C.A.2d, 1940), cert. den. 310 U.S. 637 (1940), discussed in the principal case, seemed to have established the law. Similar results were reached in *Commissioner v. Warner,* 127 F.2d 913 (C.C.A.9th, 1942), and in *Cole's Estate v. Commissioner,* 140 F.2d 636 (C.C.A.8th, 1944).[2]

Then some cases pointing the other way developed. See *In re Lueder's Estate,* 164 F.2d 128 (C.C.A.3d, 1947); *Newberry's Estate v. Commissioner,* 201 F.2d 874 (C.A.3d, 1953). The extreme appears to be found in the principal case. Can it be justified? For recent discussions see Johnson, "Reciprocal Trusts—A Tax Avoidance Device with Recuperative Powers," 36 Nebraska L.Rev. 564 (1957); Landman, "The Tax Implications of Reciprocal Trusts," 34 Taxes 346 (1956).

(B) In *Estate of Guenzel v. Commissioner,* 258 F.2d 248 (C.A. 8th, 1958), it appeared that a husband and wife in 1936 created irrevocable trusts on the same day, with securities of the same value. H's trust was for W for life, remainder to H for life, with remainder to children, while W's trust was for H for life, remainder to W for life, with remainder to children. W died in 1947. The Commissioner required the inclusion in her gross estate of the then value of the trust created by H. In 1949, H released his entire interest in the trust created by W. (It was not contended that this release was in contemplation of death.) In 1951, H

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1 To the same effect is Hanauer's Estate v. Commissioner of Internal Revenue, 2 Cir., 149 F.2d 857, at page 859, which cites § 302(d) of the Internal Revenue Act of 1926, as amended in 1934.

2 Generally, see Callman, "The Lehman Doctrine—Its Significance and Application," 26 Taxes 233 (1948); Colgan and Molloy, "Converse Trusts—The Rise and Fall of a Tax Avoidance Device," 3 Tax L.Rev. 271 (1948); Marx, "The Switching of Settlors in Inter Vivos Trusts," 26 Taxes 622 (1948).

died. The Commissioner contended that the then value of the property of the trust created by H should be included in his gross estate. This was sustained.

The court also held that no deduction was allowable to H's estate on account of property previously taxed, since H did not receive from his wife the property in the trust which he created; it came from himself. See also *Estate of Moreno v. Commissioner*, 260 F.2d 389 (C.A.8th, 1958).

5. Transfers Taking Effect at Death

Sec. 2037 of the 1954 Code

We turn now to transfers taking effect at death. These are now covered by express provisions in sec. 2037 of the 1954 Code. But much of the law in this area developed while the estate tax law contained only the general language of sec. 811(c) of the 1939 Code, and its predecessors, taxing transfers "intended to take effect in possession or enjoyment at or after" the transferor's death.[1]

An early case was:

SHUKERT v. ALLEN, 273 U.S. 545 (1927): On May 5, 1921, the testator transferred $225,000 to a trust company in trust to accumulate the income until February 1, 1951, and then to divide the principal and accumulated income among his three children by name. The testator died on September 29, 1921, but it was conceded that the transfer was not made in contemplation of death. The testator was fifty-six years old when he made the trust. The court held that the transfer was not taxable. The Court said that "it seems to us tolerably plain, that when the grantor parts with all his interest in the property to other persons in trust, with no thought of avoiding taxes, the fact that the income vested in the beneficiaries was to be accumulated for them instead of being handed to them to spend does not make the trust one intended to take effect in possession or enjoyment at or after the grantor's death."

Most of the transfers which we are now considering are ones where the interest of the beneficiary is subject to some sort of a condition. It may help in examining this problem to consider two types of transfers:

(1) *Condition precedent*. Property is transferred "to my wife for life, and if she survives me to her in fee." This is the limitation which was involved in *Klein v. United States*, 283 U.S. 231

[1] For an historical comment, see "Origin of the Phrase 'Intended to Take Effect,' etc.," in 56 Yale L.J. 176 (1946).

(1931), argued on the same day as the three per curiam cases which led to the Joint Resolution of March 3, 1931, and decided a few weeks later. It was decided that the entire value of the property was includible in the gross estate under the "general language" which imposed a tax on transfers "intended to take effect in possession or enjoyment at or after his death." The government conceded, however, that the value of the wife's life estate outstanding on the date of the transferor's death should be excluded from his gross estate.

(2) *Condition subsequent.* Property is transferred "to Doris in fee, but if she died before I do then back to me." This is the type of limitation involved in *Helvering v. Duke,* 290 U.S. 591 (1934). In that case a decision in favor of the estate was affirmed by the Supreme Court by an equally divided Court, Chief Justice Hughes being disqualified. In the following year, the Court decided the question in *Helvering v. St. Louis Union Trust Co.,* 296 U.S. 39 (1935), and *Becker v. St. Louis Union Trust Co.,* 296 U.S. 48 (1935), both five to four decisions. It was held that such a transfer did not come within the "general language," and that nothing was to be included in the gross estate upon the death of the transferor with the beneficiary surviving. (Of course, if the beneficiary died first, the transfer would terminate, and all of the property would revert to the grantor and be included in his estate on his death under the provision now found in sec. 2033 of the 1954 Code.)

HELVERING v. HALLOCK

Supreme Court of the United States, 1940. 309 U.S. 106.

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

These cases raise the same question, namely, whether transfers of property *inter vivos* made in trust, the particulars of which will later appear, are within the provisions of section 302(c) of the Revenue Act of 1926. They were heard in succession and may be decided together. In each case the Commissioner of Internal Revenue included the trust property in the decedent's gross estate. . . .

Neither here nor below does the issue turn on the unglossed text of section 302(c). In its enforcement, Treasury and courts alike encounter three recent decisions of this Court, *Klein v. United States,* 283 U.S. 231, *Helvering v. St. Louis Trust Co.,* 296 U.S. 39, and *Becker v. St. Louis Trust Co., Ibid.* 48. Because of the difficulties which lower courts have found in applying the distinctions made by these cases and the seeming disharmony of their results, when judged by the controlling purposes of the estate tax law, we brought the cases here. All involve disposi-

tions of property by way of trust in which the settlement provides for return or reversion of the corpus to the donor upon a contingency terminable at his death. Whether the transfer made by the decedent in his lifetime is "intended to take effect in possession and enjoyment at or after his death" by reason of that which he retained, is the crux of the problem. We must put to one side questions that arise under sections of the estate tax law other than section 302(c)—sections, that is, relating to transfers taking place at death. Section 302(c) deals with property not technically passing at death but with interests theretofore created. The taxable event is a transfer *inter vivos.* But the measure of the tax is the value of the transferred property at the time when death brings it into enjoyment.

We turn to the cases which beget the difficulties. In *Klein v. United States, supra,* decided in 1931, the decedent during his lifetime had conveyed land to his wife for her lifetime, "and if she shall die prior to the decease of said grantor then and in that event she shall by virtue hereof take no greater or other estate in said lands and the reversion in fee in and to the same shall in that event remain vested in said grantor, . . ." The instrument further provided, "Upon condition and in the event that said grantee shall survive the said grantor, then and in that case only the said grantee shall by virtue of this conveyance take, have, and hold the said lands in fee simple, . . ." The taxpayer contended that the decedent had reserved a mere "possibility of reverter" and that such a "remote interest,"[1] extinguishable upon the grantor's death, was not sufficient to bring the conveyance within the reckoning of the taxable estate. This Court held otherwise. It rejected formal distinctions pertaining to the law of real property as irrelevant criteria in this field of taxation. "Nothing is to be gained," it was said, "by multiplying words in respect of the various niceties of the art of conveyancing or the law of contingent and vested remainders. It is perfectly plain that the death of the grantor was the indispensable and intended event which brought the larger estate into being for the grantee and effected its transmission from the dead to the living, thus satisfying the terms of the taxing act and justifying the tax imposed." *Klein v. United States, supra,* at 234.

The inescapable rationale of this decision, rendered by a unanimous Court, was that the statute taxes not merely those interests which are deemed to pass at death according to refined technicalities of the law of property. It also taxes *inter vivos* transfers that are too much akin to testamentary dispositions not to be subjected to the same excise. By bringing into the gross estate at his death that which the settlor gave contingently upon it, this

[1] Petitioner's Brief, Klein v. United States, pp. 11–13.

Court fastened on the vital factor. It refused to subordinate the plain purposes of a modern fiscal measure to the wholly unrelated origins of the recondite learning of ancient property law. Surely the *Klein* decision was not intended to encourage the belief that a change merely in the phrasing of a grant would serve to create a judicially cognizable difference in the scope of section 302(c), although the grantor retained in himself the possibility of regaining the transferred property upon precisely the same contingency. The teaching of the *Klein* case is exactly the opposite.[2]

In 1935 the *St. Louis Trust* cases came here. A rational application of the principles of the *Klein* case to the stituations now before us calls for scrutiny of the particulars in the *St. Louis* cases in order to extract their relation to the doctrine of the earlier decision.

In *Helvering v. St. Louis Trust Co., supra,* the decedent had conveyed property in trust, the income of which was to be paid to his daughter during her life, but at her death, "If the grantor still be living, the Trustee shall forthwith . . . transfer, pay, and deliver the entire estate to the grantor, to be his absolutely." But "If the grantor be then not living" then the income was to be devoted to the settlor's wife if she were living, and upon the death of both daughter and wife, if he were not living, the trust property was to go to the daughter's children, or if she left none, to the grantor's next of kin.

In *Becker v. St. Louis Trust Co., supra,* the decedent had declared himself trustee of property with the income to be accumulated or, at his discretion, to be paid over to his daughter during her life. The instrument further provided that "If the said beneficiary should die before my death, then this trust estate shall thereupon revert to me and become mine immediately and absolutely, or . . . if I should die before her death, then this property shall thereupon become hers immediately and absolutely . . ."

On the authority of the *Klein* case the Commissioner had included in the taxable estates the gifts to which, in the *St. Louis Trust* cases, the grantor's death had given definitive measure. If the wife had predeceased the settlor in the *Klein* case, he would have been repossessed of his property. His wife's interests were freed from this contingency by the husband's prior death, and because of the effect of his death this Court swept the gift into the gross estate. So in *Helvering v. St. Louis Trust Co.,* the grantor would have become repossessed of the granted corpus had his

[2] Some indication of the influence of Klein v. United States upon the lower courts may be found in Sargent v. White, 50 F.2d 410 and Union Trust Co. v. United States, 54 F.2d 152, cert. denied, 286 U.S. 547. *Cf.* Commissioner v. Schwarz, 74 F.2d 712.

daughter predeceased him. But he predeceased her and by that event her interest ripened to full dominion. The same analysis applies to the *Becker* case. In all three situations the result and effect were the same. The event which gave to the beneficiaries a dominion over property which they did not have prior to the donor's death was an act of nature outside the grantor's "control, design or volition." 296 U.S. 39, 43. But it was no more and no less "fortuitous," so far as the grantor's "control, design or volition" was concerned, in the *St. Louis Trust* cases than it was in the *Klein* case. In none of the three cases did the dominion over property which finally came to the beneficiary fall by virtue of the grantor's will, except by his provision that his own death should establish such final and complete dominion. And yet a mere difference in phrasing the circumstance by which identic interests in property were brought into being—varying forms of words in the creation of the same worldly interests—was found sufficient to exclude the *St. Louis Trust* settlements from the application of the *Klein* doctrine.

Four members of the Court saw no difference. They relied on the governing principle of section 302(c) that Congress meant to include in the gross estate *inter vivos* gifts "which may be resorted to, as a substitute for a will, in making dispositions of property operative at death." 296 U.S. at 46. To effectuate this purpose practical considerations applicable to taxation and not the "niceties of the art of conveyancing" were their touchstone. "Having in mind," said the dissenters, "the purpose of the statute and the breadth of its language it would seem to be of no consequence what particular conveyancers' device—what particular string—the decedent selected to hold in suspense the ultimate disposition of his property until the moment of his death. In determining whether a taxable transfer becomes complete only at death we look to substance, not to form . . . However we label the device it is but a means by which the gift is rendered incomplete until the donor's death." 296 U.S. at 47. For the majority in the *St. Louis Trust Company* cases, these practicalities had less significance than the formal categories of property law. The grantor's death, the majority said, in *Helvering v. St. Louis Trust Co.*, "simply put an end to what, at best, was a mere possibility of a reverter by extinguishing it—that is to say, by converting what was merely possible into an utter impossibility." 296 U.S. 39, 43. This was precisely the mode of argument which had been rejected in *Klein v. United States, supra.*

We are now asked to accept all three decisions as constituting a coherent body of law, and to apply their distinctions to the trusts before us.

In Nos. 110, 111 and 112 *(Helvering v. Hallock)* the decedent in 1919 created a trust under a separation agreement, giving the income to his wife for life, with this further provision:

"If and when Anne Lamson Hallock shall die and in such event . . . the within trust shall terminate and said Trustee shall . . . pay Party of the First Part if he then be living any accrued income, then remaining in said trust fund and shall . . . deliver forthwith to Party of the First Part, the principal of the said trust fund. If and in the event said Party of the First Part shall not be living then and in such event payment and delivery over shall be made to Levitt Hallock and Helen Hallock, respectively son and daughter of the Party of the First Part, share and share alike . . ."

When the settlor died in 1932, his divorced wife, the life beneficiary, survived him. The Circuit Court of Appeals held that the trust instrument had conveyed the "whole interest" of the decedent, subject only to a "condition subsequent," which left him nothing "except a mere possibility of reverter." *Commissioner v. Hallock,* 102 F.2d 1, 3–4.

In No. 183 *(Rothensies v. Cassell)* the decedent by an antenuptial agreement in 1925 conveyed property in trust, the income to be paid to his prospective wife during her life, subject to the following disposition of the principal:

"In trust if the said Rae Spektor shall die during the lifetime of said George F. Uber to pay over the principal and all accumlated income thereof unto the said George F. Uber in fee, free and clear of any trust.

"In trust if the said Rae Spektor after the marriage shall survive the said George F. Uber to pay over the principal and all accumulated income unto the said Rae Spektor—then Rae Uber—in fee, free and clear of any trust."

Mrs. Uber outlived her husband, who died in 1934. The Circuit Court of Appeals deemed *Becker v. St. Louis Trust Co.* controlling against the inclusion of the trust corpus in the gross estate.

Finally, in No. 399 *(Bryant v. Helvering),* the testator provided for the payment of trust income to his wife during her life and upon her death to the settlor himself if he should survive her. The instrument, which was executed in 1917, continued:

"Upon the death of the survivor of said Ida Bryant and the party of the first part, unless this trust shall have been modified or revoked as hereinafter provided, to convey, transfer, and pay over the principal of the trust fund to the executors or administrators of the estate of the party hereto of the first part."

There was a further provision giving to the decedent and his wife jointly during their lives, and to either of them after the death of the other, power to modify, alter or revoke the instrument. The wife survived the husband, who died in 1930. The Board of Tax

Appeals allowed the Commissioner to include in the decedent's gross estate only the value of a "vested reversionary interest" which the Board held the grantor had reserved to himself. On appeal by the taxpayer, the Circuit Court of Appeals sustained this determination.

The terms of these grants differ in detail from one another, as all three differ from the formulas of conveyance used in the *Klein* and *St. Louis Trust* cases. It therefore becomes important to inquire whether the technical forms in which interests contingent upon death are cast should control our decision. If so, it becomes necessary to determine whether the differing terms of conveyance now in issue approximate more closely those used in the *Klein* case and are therefore governed by it, or have a greater verbal resemblance to those that saved the tax in the *St. Louis Trust* cases. Such an essay in linguistic refinement would still further embarrass existing intricacies. It might demonstrate verbal ingenuity, but it could hardly strengthen the rational foundations of law. The law of contingent and vested remainders is full of casuistries. There are great diversities among the several states as to the conveyancing signficance of like grants; sometimes in the same state there are conflicting lines of decision, one series ignoring the other. Attempts by the Board of Tax Appeals and the Circuit Court of Appeal to administer section 302(c) by reference to these distinctions abundantly illustrate the inevitable confusion.[3] One of the cases at bar, No. 399, reveals vividly the snares which inevitably await an attempt to base estate tax law on the "niceties of the art of conveyancing." In connection with the ascertainment of its own death duties, the Supreme Court of Errors of Connecticut defined the nature of the interest which the decedent in that case retained after his *inter vivos* transfer. *Bryant v. Hackett,* 118 Conn. 233. And yet the nature of that interest under Connecticut law and the scope of the Connecticut Court's adjudication of that interest were made the subject of lively controversy before us. The importation of these distinctions and controversies from the law of property into the administration of the estate tax precludes a fair and workable tax system. Essentially the same interests, judged from the point of view of wealth, will be taxable or not, depending upon elusive and subtle casuistries which may have their

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3 See, for example, the attempts by the Board of Tax Appeals to deal with the peculiarities of New York law in the field of vested and contingent remainders. Elizabeth B. Wallace, 27 B.T.A. 902; Louis C. Raegner, Jr., 29 B.T.A. 1243. In both of these cases limitations which would probably have been "contingent" at "common law" were held to be "vested" under the New York statutory rule. Cf. Commissioner v. Schwarz, 74 F.2d 712; Flora M. Bonney, 29 B.T.A. 45.

historic justification but possess no relevance for tax purposes.[4] These unwitty diversities of the law of property derive from medieval concepts as to the necessity of a continuous seisin.[5] Distinctions which originated under a feudal economy when land dominated social relations are peculiarly irrelevant in the application of tax measures now so largely directed toward intangible wealth.

Our real problem, therefore, is to determine whether we are to adhere to a harmonizing principle in the construction of section 302(c), or whether we are to multiply gossamer distinctions between the present cases and the three earlier ones. Freed from the distinctions introduced by the *St. Louis Trust* cases, the *Klein* case furnishes such a harmonizing principle. Does, then, the doctrine of *stare decisis* compel us to accept the distinctions made in the *St. Louis Trust* cases as starting points for still finer distinctions spun out of the tenuosities of surviving feudal law? We think not. We think the *Klein* case rejected the presupposition of such distinctions for the fiscal judgments which section 302(c) demands.

We recognize that *stare decisis* embodies an important social policy. It represents an element of continuity in law, and is rooted in the psychologic need to satisfy reasonable expectations. But *stare decisis* is a principle of policy and not a mechanical formula of adherence to the latest decision, however recent and questionable, when such adherence involves collision with a prior doctrine more embracing in its scope, intrinsically sounder, and verified by experience. . . .

This Court, unlike the House of Lords, has from the beginning rejected a doctrine of disability at self-correction. Whatever else may be said about want of Congressional action to modify by legislation the result in the *St. Louis Trust* cases, it will hardly be urged that the reason was Congressional approval of those distinctions between the *St. Louis Trust* and the *Klein* cases to which four members of this Court could not give assent. By imputing to Congress a hypothetical recognition of coherence

4 Cf. Lyeth v. Hoey, 305 U.S. 188, 194. See Paul, The Effect on Federal Taxation of Local Rules of Property in Selected Studies in Federal Taxation (2nd Series), pp. 23–28; Developments in the Law—Taxation, 47 Harv.L.Rev. 1209, 1238–41; Note, 49 Harv.L.Rev. 462.

5 See, for example, Fearne, Contingent Remainders, (4th Am.Ed.), pp. 3–241; Gray, Rule Against Perpetuities (2nd Ed.), pp. 99–118; VII Holdsworth, History of English Law, 81 et seq.; 1 Simes, Future Interests, secs. 64–96. The confusion apt to be engendered by judicial forays into this field is well illustrated by the use of the term "possibility of reverter" by the majority in Helvering v. St. Louis Union Trust Co. "A possibility of reverter" is traditionally defined as the interest remaining in a grantor who has conveyed a determinable fee. The definition has not been thought to have any relation to the reversionary interest of a grantor who has transferred either a vested or contingent remainder in fee. See Gray, Rule Against Perpetuities (2nd Ed.), secs. 13–51.

between the *Klein* and the *St. Louis Trust* cases, we cannot evade our own responsibility for reconsidering, in the light of further experience, the validity of distinctions which this Court has itself created. Our problem then is not that of rejecting a settled statutory construction. The real problem is whether a principle shall prevail over its later misapplications. Surely we are not bound by reason or by the considerations that underlie *stare decisis* to persevere in distinctions taken in the application of a statute which, on further examination, appear consonant neither with the purposes of the statute nor with this Court's own conception of it. We therefore reject as untenable the diversities taken in the *St. Louis Trust* cases in applying the *Klein* doctrine —untenable because they drastically eat into the principle which those cases professed to accept and to which we adhere.

In Nos. 110, 111, 112 and 183, the judgments are

Reversed.

In No. 399, the judgment is

Affirmed.

THE CHIEF JUSTICE concurs in the result upon the ground that each of these cases is controlled by our decision in *Klein v. United States,* 283 U.S. 231.

MR. JUSTICE ROBERTS. There is certainly a distinction in fact between the transaction considered in *Klein v. United States,* 283 U.S. 231, and those under review in *Helvering v. St. Louis Union Trust Company,* 296 U.S. 39, and *Becker v. St. Louis Union Trust Company,* 296 U.S. 48. The courts, the Board of Tax Appeals, and the Treasury have found no difficulty in observing the distinction in specific cases. I believe it is one of substance, not merely of terminology, and not dependent on the niceties of conveyancing or recondite doctrines of ancient property law.

But if I am wrong in this, I still think the judgments in Nos. 110–112, and 183 should be affirmed and that in 399 should be reversed. The rule of interpretation adopted in the *St. Louis Union Trust Company* cases should now be followed for two reasons: *First,* that rule was indicated by decisions of this court as the one applicable in the circumstances here disclosed, as early as 1927; was progressively developed and applied by the Board of Tax Appeals, the lower federal courts, and this court, up to the decision of *McCormick v. Burnet,* 283 U.S. 784, in 1931; and has since been followed by those tribunals in not less than fifty cases. It ought not to be set aside after such a history. *Secondly.* The rule was not contrary to any treasury regulation; was, indeed, in accord with such regulations as there were on the subject; was subsequently embodied in a specific regulation, and, with this background, Congress has three times reënacted the law without amending section 302(c) in respect of the matter here in issue.

The settled doctrine, that reënactment of a statute so construed, without alteration, renders such construction a part of the statute itself, should not be ignored but observed. . . .

Since the *St. Louis* cases were decided, the principle on which they went has been repeatedly applied by the Board of Tax Appeals and the courts. The Board has followed the cases in no less than seventeen instances.

The record is the same in the courts. The *St. Louis* cases have been followed in fourteen cases. In some of these the Government has sought review in this court but in none, except those now presented, has it asked the court to overrule those decisions.

If there ever was an instance in which the doctrine of *stare decisis* should govern, this is it. Aside from the obvious hardship involved in treating the taxpayers in the present cases differently from many others whose cases have been decided or closed in accordance with the settled rule, there are the weightier considerations that the judgments now rendered disappoint the just expectations of those who have acted in reliance upon the uniform construction of the statute by this and all other federal tribunals; and that, to upset these precedents now, must necessarily shake the confidence of the bar and the public in the stability of the rulings of the courts and make it impossible for inferior tribunals to adjudicate controversies in reliance on the decisions of this court. To nullify more than fifty decisions, five of them by this court, some of which have stood for a decade, in order to change a mere rule of statutory construction, seems to me an altogether unwise and unjustified exertion of power. . . .

MR. JUSTICE MCREYNOLDS joins in this opinion.

Note

In T.D. 5008, 1940–2 Cum.Bull. 286, which became sec. 81.17 of Regulations 105, the Treasury ruled that the *Hallock* case would not be applied to transfers which were made between November 11, 1935, and January 29, 1940, these being the dates of the decisions of the *St. Louis Union Trust* case and the *Hallock* case, respectively.

The *Hallock* case opened up a great many problems. Some of them are indicated below:

(1) Did it make any difference whether the reversionary interest was expressly reserved, or was effective as a matter of law in the absence of a wholly complete disposition of the property to others?

(2) Was it possible to draft a transfer which would not involve any possibility of a reversionary interest? If so, how? Was

there not some possibility that any supposedly fixed remainder interest might fail, with a resulting reversion to the transferor?

(3) If a transfer had already been made with a reversionary interest, and the transferor was still living, was there anything he could do to take the property out of his gross estate? Could he, for example, give his reversionary interest to a charity?

(4) Did it make any difference how remote the reversionary interest was? Suppose the property would come back only if the transferor survived his four children, and ten grandchildren, and any further grandchildren and their issue? The actuarial value of such a possibility might be very small, less than one in a million. Should it nevertheless result in including the entire value of the property in the gross estate?

(5) If it should be concluded that a very remote reversionary interest should not result in tax, where should the line be drawn? What is a "very remote" reversionary interest? What authority is there in the statute for drawing a line?

(6) Suppose there was a reversionary interest, but it did not turn on survivorship of the transferor. Such a transfer might be, for example, "to my son for life, remainder to his children for life, remainder to their children in fee, but if my son's children all die without issue, then back to me, if I am living, or to my estate."

In a number of cases, the Supreme Court took a very strict view, holding that the entire value of the property was includible in the gross estate if there was any reversionary interest, no matter how remote. See *Fidelity-Philadelphia Trust Co. v. Rothensies,* 324 U.S. 108 (1945); *Commissioner v. Estate of Field,* 324 U.S. 113 (1945); *Goldstone v. United States,* 325 U.S. 687 (1945). Indeed, it is difficult to see how this result could be avoided under the statute as written; but the Supreme Court did not attempt in any way to soften its language. For example, in the *Fidelity-Philadelphia Trust* case it said: "No more should the measure of the tax depend upon conjectures as to the propinquity or certainty of the decedent's reversionary interests. It is enough if he retains some contingent interest in the property until his death or thereafter, delaying until then the ripening of full dominion over the property by the beneficiaries. The value of the property subject to the contingency, rather than the actuarial or theoretical value of the possibility of the occurrence of the contingency, is the measure of the tax." [1]

[1] There were numerous discussions of the general Hallock problem. See, especially, Eisenstein, "The Hallock Problem: A Case Study in Administration," 58 Harv.L.Rev. 1141 (1945). See also Nelson, "Reverters in Estate Taxation," 23 Taxes 98 (1945); Johnson, "Estate Tax on Inter Vivos Trans-

The "Hallock Regulations"

In 1946, the Treasury undertook to resolve some of the questions. It issued a rather comprehensive regulation which appeared as T.D. 5512, 1946–1 Cum.Bull. 264. This was included with some further amendments, in sec. 81.17 of Regulations 105.

The Treasury's regulations were discussed in Platt, "The New Hallock Regulation," 2 Tax L.Rev. 94 (1946).

The Spiegel Case

Thus the matter stood until the Supreme Court entered the fray again. The law relating to transfers with conditions was fairly clear, although somewhat harsh as far as very remote reversionary interests were concerned. But it was not unduly difficult to avoid such reversionary interests in drafting transfers, nor to dispose of them where they had been included and were discovered before the transferor died.

The Supreme Court's decision in the *Church* case in 1949 has already been referred to, in connection with the consideration of retained life estates. Another case was considered at the same time and decided on the same day, involving a conditional transfer. This was *Estate of Spiegel v. Commissioner,* 335 U.S. 701 (1949).

There was nothing particularly unusual about the *Spiegel* case, except that the reversionary interest was very remote, and arose entirely by operation of law. The Court's decision that the entire value of the transferred property was taxable was quite consistent with its earlier decisions in the field since the *Hallock* case. But the opinion, written by Mr. Justice Black, contained some very sweeping language, going in a number of respects quite beyond the facts of the case.[1]

The 1949 Statute

The Technical Changes Act of 1949 (to which reference has already been made in connection with retained life estates) also dealt with transfers taking effect at death.[2] The new statutory provision was based upon the Hallock regulations, but with some

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fers—Contingent Reversions not Dependent upon Grantor's Death," 1 Tax L. Rev. 95 (1945); Alexander, "Possibilities of Reacquisition and The Federal Estate Tax," 1 Tax L.Rev. 291 (1946); Eisenstein, "Another Glance at the Hallock Problem," 1 Tax L.Rev. 430 (1946).

1 For discussion see Bittker, "The Church and Spiegel Cases: Section 811(c) Gets a New Lease on Life," 58 Yale L.J. 825 (1949); "Church and Spiegel in Perspective," 16 U. of Chi.L.Rev. 711 (1949); "The Church and Spiegel Cases: The Meaning of a Transfer Effective at Death," 49 Col.L.Rev. 533 (1949).

2 See Lowndes, "The Constitutionality of the New Federal Estate Tax Definition of a Transfer Taking Effect at Death," 3 Vanderbilt L.Rev. 203 (1950).

modifications. A number of further changes were made in the statute after 1949, and it has finally developed into the form now found in sec. 2037 of the 1954 Code.

Note that the statute now expressly provides that it applies only to transfers made after September 7, 1916. Thus the retention of a reversionary interest prior to the enactment of the first estate tax will not result in a tax on the death of the transferor.

Where the transfer was before October 8, 1949 (the date of enactment of the Technical Changes Act of 1949), a reversionary interest will not make the transfer taxable unless it was expressly reserved. For transfers after that date, a reversionary interest arising by operation of law (an implied reversion) has the same effect as one expressly reserved.

Problems

(A) Suppose a person makes a transfer which would be subject to sec. 2037 of the 1954 Code. Thereafter he transfers his reversionary interest to another. Later he dies. Is the property includible in his gross estate. What would the result be if the reversion was transferred in contemplation of death. How much would be included in that event—the value of the reversion transferred, or the entire value of the property?

(B) Suppose that A transfers property on trust to pay the income to B for the life of A, and to pay the principal to C on A's death. Is the property taxable in A's estate? See sec. 2037 of the 1954 Code.

6. Revocable Transfers

Sec. 2038 of the 1954 Code

As things have worked out, questions arising with respect to revocable trusts, and the closely related questions of trusts in which a power to alter or amend is reserved, have been the least difficult of the problems arising under the statutory provisions taxing inter vivos transfers.

The provisions now found in sec. 2038 of the 1954 Code first made their appearance in 1924. They were later included in sec. 811(d) of the 1939 Code. Prior to 1924, the statutes contained only the general language taxing transfers "intended to take effect in possession and enjoyment at or after his death." The first important case involving a revocable trust arose under this general language above, since the decedent died in 1922. This is:

REINECKE v. NORTHERN TRUST CO.

Supreme Court of the United States, 1929. 278 U.S. 339.

MR. JUSTICE STONE delivered the opinion of the Court.

Respondent executor brought suit in the District Court for northern Illinois to recover from petitioner, a collector of Internal Revenue, the amount of a tax alleged to have been illegally assessed and collected upon the estate of respondent's testator under the Revenue Act of 1921, c. 136, 42 Stat. 227. Judgment of the district court for the executor, upon an overruled demurrer, was affirmed by the Court of Appeals for the Seventh Circuit. 24 F.2d 91. This Court granted certiorari April 23, 1928, 277 U.S. 579.

Respondent's testator died May 30, 1922. On various dates between 1903 and 1919 he established seven trusts by deed which are conceded not to have been in contemplation of death. Two of them were created respectively in 1903 and 1910. They are identified in the record as Trusts No. 1831 and No. 3048, and referred to here as the "two trusts." By them the income from the trusts was reserved to the settlor for life and on his death the income of each trust was to be paid to a designated person until the termination of the trust as provided in the trust instrument, with remainders over. By the terms of each trust there was reserved to the settlor alone a power of revocation of the trusts, upon the exercise of which the trustee was required to return the corpus of the trust to him.

The remaining five trusts, designated in the record as Trusts Nos. 4477, 4478, 4479, 4480 and 4481, referred to here as the "five trusts," were created in 1919 before the passage of the Revenue Act of 1921, but after the enactment of the similar provisions of the estate tax of the Revenue Act of 1918. 40 Stat. 1096, 1097. By each, life interests in the income, on terms not now important, were created. In one the life interest was terminable five years after the death of the settlor or on the death of the designated life beneficiary should she survive that date, with a remainder over. In the other four, life interests in the income were created, terminable five years after the settlor's death or on the death of the respective life tenants, whichever should first happen, with remainders over. The settlor reserved to himself power to supervise the reinvestment of trust funds, to require the trustee to execute proxies to his nominee, to vote any share of stock held by the trustee, to control all leases executed by the trustee, and to appoint successor trustees. With respect to each of these five trusts a power was also reserved "to alter, change or modify the trust," which was to be exercised in the case of four of them by the settlor and the single benefi-

ciary of each trust, acting jointly, and in the case of one of the trusts, by the settlor and a majority of the beneficiaries named, acting jointly.

The settlor died without having revoked either of the two trusts and with the beneficiaries and life tenants designated in the trusts surviving him, and without having modified any of the five trusts except one, and that in a manner not now material.

The commissioner, in fixing the amount of the estate for tax purposes included the corpus of all seven trusts. Section 401 of the statute imposes a tax at a graduated rate "upon the transfer of the net estate of every decedent" dying after the passage of the act. By 402 it is provided that in calculating the tax there shall be included in the gross estate all property, tangible and intangible, "(c) To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death (whether such transfer or trust is made or created before or after the passage of this Act). . . ."

As to the two trusts, it is argued that since they were created long before the passage of any statute imposing an estate tax the taxing statute if applied to them is unconstitutional and void, because retroactive, within the ruling of *Nichols v. Coolidge,* 274 U.S. 531. In that case it was held that the provisions of the similar section 402 of the 1918 Act, 40 Stat. 1097, making it applicable to trusts created before the passage of the act was in conflict with the Fifth Amendment of the federal Constitution and void, as respects transfers completed before any such statute was enacted. But in *Chase National Bank v. United States,* decided this day [278 U.S.] 327, the decision is rested on the ground, earlier suggested with respect to the Fourteenth Amendment in *Saltonstall v. Saltonstall,* 276 U.S. 260, 271, that a transfer made subject to a power of revocation in the transferor, terminable at his death, is not complete until his death. Hence section 402, as applied to ~~the present transfers~~, is not retroactive, since his death followed the passage of the statute. For that reason, stated more at length in our opinion in ~~*Chase National Bank v. United States,*~~ *supra,* ~~we hold that the tax was rightly~~ imposed on the transfers of the corpus of the two trusts and as to them the judgment of the ~~court of appeals should be reversed.~~

It is argued by respondent that section 402 by its terms does not impose any tax on the transfers involved in the five trusts and that, even if subject to the provisions of that section, they antedated the passage of the 1921 act, and the section as to them is retroactive and void, although they were created after the enactment of the corresponding sections of the 1918 act. The gov-

ernment argues that section 402 applies to all these transfers and is not retroactive as to them because of the reserved powers to manage and to modify the trusts, which did not terminate until the death of the decedent after the passage of the statute, and that even without such reserved powers the transfers of the remainder interests were all subject to the tax because, within the language of section 402, they were "intended to take effect in possession or enjoyment at or after his death."

As the tax cannot be supported unless the statute applies in one of the two ways suggested by the government, we must necessarily determine the effect of the reserved powers and the meaning and application of the phrase quoted from section 402. If it be assumed that the power to modify the trust was broad enough to authorize disposition of the trust property among new beneficiaries or to revoke the trusts, still it was not one vested in the settlor alone, as were the reserved powers in the case of the two trusts. He could not effect any change in the beneficial interest in the trusts without the consent, in the case of four of the trusts, of the person entitled to that interest, and in the case of one trust without the consent of a majority of those so entitled. Since the power to revoke or alter was dependent on the consent of the one entitled to the beneficial, and consequently adverse, interest, the trust, for all practical purposes, had passed as completely from any control by decedent which might inure to his own benefit as if the gift had been absolute.

Nor did the reserved powers of management of the trusts save to decedent any control over the economic benefits or the enjoyment of the property. He would equally have reserved all these powers and others had he made himself the trustee, but the transfer would not for that reason have been incomplete. The shifting of the economic interest in the trust property which was the subject of the tax was thus complete as soon as the trust was made. His power to recall the property and of control over it for his own benefit then ceased and as the trusts were not made in contemplation of death, the reserved powers do not serve to distinguish them from any other gift *inter vivos* not subject to the tax.

But the question much pressed upon us remains, whether, the donor having parted both with the possession and his entire beneficial interest in the property when the trust was created, the mere passing of possession or enjoyment of the trust fund from the life tenants to the remaindermen after the testator's death, as directed, and after the enactment of the statute, is included within its taxing provisions. That question, not necessarily involved, was left unanswered in *Shukert v. Allen,* 273 U. S. 545. There the gift of a remainder interest, having been made without reference to the donor's death, although it did

in fact vest in possession and enjoyment after his death, was held not to be a transfer intended to take effect in possession or enjoyment at or after the donor's death, and for that reason not to be subject to the tax. But here the gift was intended to so take effect, although the transfer which effected it preceded the death of the settlor and was itself not subject to the tax unless made so by the circumstances that the possession or enjoyment passed as indicated.

In its plan and scope the tax is one imposed on transfers at death or made in contemplation of death and is measured by the value at death of the interest which is transferred. *Cf. Y. M. C. A. v. Davis,* 264 U.S. 47, 50; *Edwards v. Slocum,* 264 U.S. 61, 62; *N. Y. Trust Co. v. Eisner,* 256 U.S. 345, 349. It is not a gift tax, and the tax on gifts once imposed by the Revenue Act of 1924, c. 234, 43 Stat. 313, has been repealed, 44 Stat. 126. One may freely give his property to another by absolute gift without subjecting himself or his estate to a tax, but we are asked to say that this statute means that he may not make a gift *inter vivos,* equally and absolute and complete, without subjecting it to a tax if the gift takes the form of a life estate in one with the remainder over to another at or after the donor's death. It would require plain and compelling language to justify so incongruous a result and we think it is wanting in the present statute.

It is of significance, although not conclusive, that the only section imposing the tax, section 401, does so on the net estate of decedents, and that the miscellaneous items of property required by section 402 to be brought into the gross estate for the purpose of computing the tax, unless the present remainders be an exception, are either property transferred in contemplation of death or property passing out of the control, possession or enjoyment of the decedent at his death. They are property held by the decedent in joint tenancy or by the entirety, property of another subject to the decedent's power of appointment, and insurance policies effected by the decedent on his own life, payable to his estate or to others at his death. The two sections, read together, indicate no purpose to tax completed gifts made by the donor in his lifetime not in contemplation of death where he has retained no such control, possession or enjoyment. In the light of the general purpose of the statute and the language of section 401 explicitly imposing the tax on net estates of decedents, we think it at least doubtful whether the trusts or interests in a trust intended to be reached by the phrase in section 402(c) "to take effect in possession or enjoyment at or after his death," include any others than those passing from the possession, enjoyment or control of the donor at his death and so taxable as transfers at death under section 401. That doubt must be resolved in favor of the taxpayer. *Gould v. Gould,* 245 U.S. 151, 153; *United States v. Merriam,*

263 U.S. 179, 187. Doubts of the constitutionality of the statute, if construed as contended by the government, would require us to adopt the construction, at least reasonably possible here, which would uphold the act. *United States v. Delaware & Hudson Co.,* 213 U.S. 366, 407; *United States v. Standard Brewery,* 251 U.S. 210, 220; *United States v. Jin Fuey Moy,* 241 U.S. 394, 401, 402; *Panama Railroad Co. v. Johnson,* 264 U.S. 375, 390. The judgment below

As to the two trusts, Nos. 1831, 3048—

Reversed.

As to the five trusts, Nos. 4477, 4478, 4479, 4480, and 4481—

Affirmed.

HELVERING v. CITY BANK FARMERS TRUST COMPANY

Supreme Court of the United States, 1935. 296 U.S. 85.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The Revenue Act of 1926, Section 302(d),[1] *provides:*

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated — . . .

"(d) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke. . . ."

The questions for decision are whether the section requires inclusion in the gross estate of the value of the corpus of a trust established in 1930 where the creator reserved a power to revoke or modify, to be exercised jointly with a beneficiary and the trustee; and whether, if such value is to be included in the gross estate, the section offends the Fifth Amendment.

By a writing dated February 21, 1930, Gertrude Feldman James, a non-resident citizen, transferred securities to the respondent as trustee, the trust to last during the lives of her two daughters or the survivor of them. The income was to be paid to her until her death, or until the termination of the trust, whichever should first occur. After her death, her husband surviving, the income was to be paid to him. If he did not outlive her, or upon his death, the income was to be distributed amongst their issue *per stirpes.* At the termination of the trust the

[1] C. 27, 44 Stat. 9, 70; U.S.C.App., Tit. 26, Sec. 1094.

corpus was to be delivered to the husband, if he were alive; if not, to the settlor, if living, or, if she were dead, to the beneficiaries at that time entitled to receive the income; if there were none such, to the heirs at law of the husband. The trust was irrevocable save that the settlor reserved the right to modify, alter or revoke it, in whole or in part, or to change any beneficial interest, any such revocation or alteration to be effected with the written consent of the trustee and her husband or, if the husband were dead, of the trustee and her brother. If they could not agree the decision of the husband or of the brother, as the case might be, was to be final. Samuel James, the husband, survived the grantor, whose death occurred before the termination of the trust, and he is in receipt of the income.

The petitioner included the value of the corpus of the trust in Mrs. James' gross estate and determined a deficiency of tax. The Board of Tax Appeals reversed, holding that Section 302(d) did not apply. The Circuit Court of Appeals affirmed the Board's decision. We granted the writ of certiorari because the decision below conflicts with that in another circuit. We hold that the section covers this case and as so applied is valid.

The Circuit Court of Appeals thought our decisions in *Reinecke v. Northern Trust Company,* 278 U.S. 339, required the language of the Act to be construed as tantamount to "in conjunction with any person not a beneficiary." So limited it is inapplicable to the trust in question.

The *Reinecke* case involved Section 402(c) of the Revenue Act of 1921 (substantially Section 302(c) of the Revenue Act of 1926) which directed the inclusion in the gross estate of all property "To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death . . ." It was held that a gift beyond the power of the grantor to alter, amend or revoke could not be said to take effect in possession or enjoyment at or after his death. Conversely, one which he alone held the power to revoke or modify came within the section, since, at his death, substantial interests passed from his control and were for the first time confirmed in others. The case involved nothing more than a determination whether the transfers were complete when made. If they were the statute did not reach them. Here we have a different problem, for section 302(d) of the 1926 Act on its face embraces Mrs. James' transfer, although complete when made and thereafter beyond her own unfettered control.

The respondent says that the section ought to be construed in the light of the analogous Section 219(g). The latter, part of

the income tax title, is "Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person, not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." The two sections have a cognate purpose but they exhibit marked differences of substance. The one speaks of a power to be exercised with one not a beneficiary; the other of a power to be exercised with any person. The one refers to a power to revest the corpus in the donor; the other has no such limitation.[8] It is true, the Report of the Ways and Means Committee on Section 302(d) said "this provision is in accord with the principle of Section 219(g) of the bill which taxes to the grantor the income of a revocable trust."[9] But to credit the assertion that the difference in phraseology is without significance and in both sections Congress meant to express the same thought, would be to disregard the clear intent of the phrase "any person" employed in Section 302(d). We are not at liberty to construe language so plain as to need no construction,[10] or to refer to Committee reports where there can be no doubt of the meaning of the words used.[11] The section applies to this transfer.

We are next told that if the Act means what it says it taxes a transfer as one taking effect at death though made prior to death and complete when made; that to do this is arbitrary and deprives the taxpayer of property without due process.

The section was first introduced into the Revenue Act of 1924, and re-enacted in that of 1926. Mrs. James created her trust in 1930. She was, therefore, upon notice of the law's command, and there can be no claim that the statute is retroactive in its application to her transfer.

The inquiry is whether it is arbitrary and unreasonable to prescribe for the future that, as respects the estate tax, a transfer, complete when made, shall be deemed complete only at the transferor's death, if he reserves power to revoke or alter exercisable jointly with another.

The respondent insists that a power to recall an absolute and complete gift only with the consent of the donee is in truth no power at all; that in such case the so-called exercise of the power is equivalent to a new gift from the donee to the donor. And so it is claimed that the statute arbitrarily declares that to exist which in fact and law is nonexistent. The position is un-

8 Compare Porter v. Commissioner, 288 U.S. 436.

9 H.R.No.179, 68th Cong., 1st Sess., p. 28.

10 Hamilton v. Rathbone, 175 U.S. 414, 419; Thompson v. United States, 246 U.S. 547, 551.

11 Wilbur v. Vindicator Gold Mining Co., 284 U.S. 231, 237.

tenable. The purpose of Congress in adding clause (d) to the section as it stood in an earlier act was to prevent avoidance of the tax by the device of joining with the grantor in the exercise of the power of revocation someone whom he believed would comply with his wishes. Congress may well have thought that a beneficiary who was of the grantor's immediate family might be amenable to persuasion or be induced to consent to a revocation in consideration of other expected benefits from the grantor's estate. Congress may adopt a measure reasonably calculated to prevent avoidance of a tax. The test of validity in respect of due process of law is whether the means adopted is appropriate to the end. A legislative declaration that a status of the taxpayer's creation shall, in the application of the tax, be deemed the equivalent of another status falling normally within the scope of the taxing power, if reasonably requisite to prevent evasion, does not take property without due process. But if the means are unnecessary or inappropriate to the proposed end, are unreasonably harsh or oppressive, when viewed in the light of the expected benefit, or arbitrarily ignore recognized rights to enjoy or to convey individual property, the guarantee of due process is infringed.

Illustrations are not lacking of cases falling on either side of the line.

Congress may require that property transferred in contemplation of death, although the transfer is so remote in time as not to comply with the requirements of a gift *causa mortis,* shall nevertheless be treated as part of the estate for purposes of taxation: this for the prevention of evasion and the giving of practical effect to the exercise of admitted power.[12] This is true despite the fact that the statutory prescription embraces gifts *inter vivos* which are in fact fully executed, irrevocable and cannot be defeated.[13]

Although property received by gift from another is capital in the hands of the donee the gain upon a sale may be measured by the cost to the donor rather than the value at the time of acquisition by the donee.[14]

It is competent for Congress, in order to avoid the evasion of tax, to declare that when one has placed his property in trust subject to a right of revocation in himself and another who is not the beneficiary he shall, nevertheless, be deemed to control the property in such sense that the income therefrom shall be treated as his income for the levying of a tax.[15] So also where

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12 Nichols v. Coolidge, 274 U.S. 531, 542; Milliken v. United States, 283 U.S. 15, 20; United States v. Wells, 283 U.S. 102, 116.

13 United States v. Wells, supra.

14 Taft v. Bowers, 278 U.S. 470, 483.

15 Reinecke v. Smith, 289 U.S. 172, 177.

an irrevocable trust is established to pay for insurance on the settlor's life, to collect the policy upon his death, and to hold or apply the proceeds for the benefit of his dependents, Congress may declare the income of the trust fund taxable to the settlor as part of his own income.[16]

In the instances cited the power to levy an excise upon the testamentary transfers or to tax income was conceded. To effectuate the exercise of this admitted power and to prevent evasion Congress was held to have acted reasonably in including within the sweep of the statute a status or an act not normally within its reach.

There are, however, limits to the power of Congress to create a fictitious status under the guise of supposed necessity. Thus it has been held that an act creating a conclusive presumption that a gift made within two years prior to death was made by the donor in contemplation of death, and requiring the value of the gift to be included in computing the estate of the decedent subject to transfer tax, is so grossly unreasonable as to violate the due process clause of the Fifth Amendment.[17] In the same category falls a statute seeking to tax the separate income of a wife as income of her husband.[18]

In view of the evident purpose of Congress we find nothing unreasonable or arbitrary in the provisions of Section 302(d) of the Revenue Act of 1926 as applied in the circumstances of this case. It was appropriate for Congress to prescribe that if, subsequent to the passage of that Act, the creator of a trust estate saw fit to reserve to himself jointly with any other person the power of revocation or alteration, the transaction should be deemed to be testamentary in character, that is, treated for the purposes of the law as intended to take effect in possession or enjoyment at the death of the settlor.

The judgment is reversed.

MR. JUSTICE VAN DEVANTER, MR. JUSTICE MCREYNOLDS, MR. JUSTICE SUTHERLAND and MR. JUSTICE BUTLER are of opinion that the judgment should be affirmed.

Notes and Problems

(A) In *Helvering v. Helmholz,* 296 U.S. 93 (1935), the trust was created in 1918. It could be revoked by the settlor with the consent of all the then beneficiaries. The Court held this was not taxable because (1) it was a completed transfer in 1918, and (2) the power reserved was nugatory. The Court said (p. 97): "This argument overlooks the essential difference between a

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16 Burnet v. Wells, 289 U.S. 670.

17 Heiner v. Donnan, 285 U.S. 312. Compare Schlesinger v. Wisconsin, 270 U.S. 230.

18 Hoeper v. Tax Commission, 284 U.S. 206.

power to revoke, alter or amend, and a condition which the law imposes. The general rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust."

Was the Court's interpretation of the power correct, since there were possible unborn beneficiaries whose consent was not required? Compare Lowndes, "Federal Taxation of North Carolina Trusts for Unborn and Unascertained Beneficiaries," 20 N.C. L.Rev. 278 (1942).

Compare *Delaney v. Gardner,* 204 F.2d 855 (C.A.1st, 1953), where the decedent had transferred the family residence to a non-stock corporation. The members could amend the by-laws, which might have resulted in a return of the property to her. The court held the property was not taxable in her estate.

(B) Does the Court's language in the *Helmholz* case mean that no power conferred by law is within the statute? Consider Calif. Civil Code, sec. 2280, which reads: "Unless expressly made irrevocable by the instrument creating the trust, every voluntary trust shall be revocable by the trustor by writing filed with the trustee." See Cappa, "The Effect of Sec. 2280 of the California Civil Code on the Federal Estate Tax Liability," 15 So.Calif.L. Rev. 155 (1942). A Louisiana statute made all gifts from husband to wife revocable. It was held that such a gift was taxable on the husband's death. *Howard v. United States,* 125 F.2d 986 (C.C.A.5th, 1942), noted in 55 Harv.L.Rev. 684 (1942); *Vaccaro v. United States,* 149 F.2d 1914 (C.C.A.5th, 1945). It is not surprising that the Louisiana statute has been repealed. La.Acts 1942, No. 187.

(C) In *White v. Poor,* 296 U.S. 98 (1935), *A* created a trust of which she was one of the trustees, and the trustees had power to revoke. Later *A* resigned as a trustee and *B* was appointed in her place. Then *B* resigned, and *A* was appointed by the other trustees to fill the vacancy. On *A's* death, it was held that the property was not taxable. The Court said (p. 102): "She then acquired any power for the future to participate in a termination of the trust solely by virtue of the action of the other trustees and the beneficiaries and not in any sense by virtue of any power reserved to herself as settlor in the original declaration of trust. We think, therefore, that neither technically nor in substance does the power to terminate as it existed from 1921 to the date of Mrs. Sargent's death fall within Section 302(d)."

This was corrected by the enactment of section 805 of the Revenue Act of 1936, which amended section 302(d)—now section 2038(a)(1) of the 1954 Code—by adding the parentheses "(in whatever capacity exercisable)," and "(without regard to when or from what source the decedent acquired such power)."

(D) Suppose the trustee or some third person has power to revoke without any intervention by the settlor. Is such a transfer within 2038? See *Helvering v. St. Louis Union Trust Co.,* 296 U.S. (1935); Lowndes and Kramer, Federal Estate and Gift Taxes (1956) 179–182. Compare the income tax provisions in secs. 676 and 677 of the 1954 Code. Consider the possibility that

the trustees or other persons holding the power might be the bank of which the settlor is president, or his brother, or his wife.

Is there any reason for the distinction between the income and estate tax provisions which is disclosed by the principal case?

When the statute was amended in 1924, it covered not only powers to revoke but also powers to "alter or amend."

In 1936, this provision, now found in sec. 2038(a)(1) of the 1954 Code, was amended so that it now applies where the power reserved is one "to alter, amend, revoke or terminate."

PORTER v. COMMISSIONER

Supreme Court of the United States, 1933. 288 U.S. 436.

MR. JUSTICE BUTLER delivered the opinion of the Court.

The question presented is whether, for the purpose of determining the tax liability of the estate of the deceased, section 302 (d) of the Revenue Act of 1926,[1] requires that there shall be included in the value of the gross estate certain bonds that he had transferred in trust.

October 18, 1918, and again on February 1, 1919, decedent transferred to the Bankers Trust Company certain bonds for the benefit of his daughter and her son. Contemporaneously he made similar transfers of bonds to the same trustee for the benefit of his son and his son's daughter. November 27, 1926, in order to make provision for two children of his daughter born after the creation of these trusts he sent the trust company letters purporting to revoke the trusts of which she was a beneficiary, to terminate the interest of all persons therein and to direct it to deliver the principal and income to itself as trustee according to a new deed then delivered. Each of the five trust agreements included provisions governing the management, investment, and disposition of principal and income, and contained a paragraph reserving to the donor power at any time to alter or modify the indenture and any or all of the trusts in any manner but expressly excepting any change in favor of himself or his estate.[2]

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1 44 Stat. 71. 26 U.S.C., sec. 1094(d).

2 Paragraph tenth in each of the transfers is as follows:

"Notwithstanding anything to the contrary herein contained, the Donor at any time during the continuance of the trust herein provided for may, by instrument in writing executed and acknowledged or proved by him in the manner required for a deed of real estate (so as to enable such deed to be recorded in the State of New York) delivered to the trustee, or its successor, modify or alter in any manner this indenture and any or all of the trusts then existing and the limitations and estates and interest in property hereby created and provided for subsequent to such trusts; and in case of such modification or

Deceased died November 30, 1926. The Commissioner of Internal Revenue included in the gross estate the value of the property described in the last deed and petitioners sought redetermination. The Board of Tax Appeals, because of the reserved power to alter and amend, held section 302(d) applied, and included the corpus of all the trusts in the gross estate. 23 B.T.A. 1016. The Circuit Court of Appeals affirmed that ruling. 60 F.2d 673. Its decision being in conflict with that of the Circuit Court of Appeals for the First Circuit in *Brady v. Ham*, 45 F.2d 454, and that of the Court of Appeals of the District of Columbia in *Cover v. Burnet,* 53 F.2d 915, we granted a writ of certiorari.

By the trust agreements, decedent divested himself of all interest in the bonds and, subject only to the reserved power, transferred full title to the trustee and beneficiaries. The reservation is broad; evidently he intended to be free at any time and from time to time to alter or modify the disposition of the property as he might see fit, subject to the restriction above mentioned. The power did not amount to an estate or interest in the property. It was much like, and for the purposes of this case may be deemed the substantial equivalent of, a general power of appointment by will. *Cf. United States v. Field,* 255 U.S. 257, 263. *Patterson v. Lawrence,* 83 Ga. 703, 707. *Clapp v. Ingraham,* 126 Mass. 200. . . .

Petitioners contend that the only thing taxed is the transfer of the net estate at death and that property in which the decedent then held no interest or power of enjoyment must be excluded. They rely on *Reinecke v. Trust Co.,* 278 U.S. 339. But that case is not in point. It involved seven trusts created by the decedent. Two were held taxable because subject to a power of revocation in him alone. In each of the others he reserved power to alter, change or modify, to be exercised in four by joint action of himself and a single beneficiary and in the remaining one by himself and a majority of the beneficiaries acting jointly. As the title was put beyond his control, we held these transfers not taxable. And petitioners assume, as held

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alteration said instrument shall direct the revised disposition to be made of the trust fund or the income thereof, or that part of the trust fund or the income thereof affected by such modification or alteration, and upon the delivery of such instrument to the Trustee or its successor said instrument shall take effect according to its provisions, and the Trustee or its successors shall make and execute all such instruments, if any, and make such conveyance, transfer or deliveries of property as may be necessary or proper in order to carry the same into effect, and no one, born or unborn, shall have any right, interest, or estate under this indenture except subject to the proper modification or alteration thereof; but this power to modify or alter is not intended and shall not be construed to include the right to the Donor to make such modification or alteration in his own favor or in favor of his estate, but shall apply only so far as the interest of third parties may be concerned."

in *White v. Erskine,* 47 F.2d 1014, that (a) is a limitation upon (d) and argue that the gross estate includes property only to the extent of the "interest therein of the decedent at the time of his death" and that, as before his death he had divested himself of all title, the property so transferred is not to be included in the gross estate. But the construction thus taken for granted cannot be sustained. Subdivision (a) does not in any way refer to or purport to modify (d) and, in view of the familiar rule that tax laws are to be construed liberally in favor of taxpayers, it cannot be said that, if it stood alone, (a) would extend to the transfers brought into the gross estate by (d). *United States v. Field, supra,* 264. Moreover, Congress has progressively expanded the bases for such taxation. Comparison of section 302 with corresponding provisions of earlier Acts warrants the conclusion that (d) is not a mere specification of something covered by (a) but that it cover something not included therein. *Cf. Chase National Bank v. United States,* 278 U.S. 327. *Tyler v. United States,* 281 U.S. 497. *Gwinn v. Commissioner,* 287 U.S. 224. *Burnet v. Guggenheim,* 228 U.S. 280.

The net estate upon the transfer of which the tax is imposed, is not limited to property that passes from decedent at death. Subdivision (d) requires to be included in the calculation all property previously transferred by decedent, the enjoyment of which remains at the time of his death subject to any change by the exertion of a power by himself alone or in conjunction with another. Petitioner argues that, as decedent was without power to revoke the transfers or to alter or modify the trusts in favor of himself or his estate, the property is not covered by subdivision (d). But the disjunctive use of the words "alter," "modify" and "amend" negatives that contention. We find nothing in the context or in the policy evidenced by this and prior estate tax laws or in the legislative history of subdivision (d) to suggest that conjunctive use of these words was intended, or that "alter" and "modify" were used as equivalents of "revoke" or are to be understood in other than their usual meanings. We need not consider whether every change, however slight or trivial, would be within the meaning of the clause. Here the donor retained until his death power enough to enable him to make a complete revision of all that he had done in respect of the creation of the trusts even to the extent of taking the property from the trustees and beneficiaries named and transferring it absolutely or in trust for the benefit of others. So far as concerns the tax here involved, there is no difference in principle between a transfer subject to such changes and one that is revocable. The transfers under consideration are undoubtedly covered by subdivision (d).

Petitioners contend that so construed section 302(d) is repugnant to the due process clause of the Fifth Amendment.

They insist, and we assume, that the measures taken by means of decedent's letter to the trustee and the new deed of November 27, 1926, operated merely to alter and modify but did not supersede the earlier trusts made for the benefit of his daughter and her son. They maintain that inclusion of the transfers in question would be to measure decedent's tax by property belonging to others, a thing condemned in *Heiner v. Donnan,* 285 U.S. 312, and *Hoeper v. Tax Commission,* 284 U.S. 206, and would be to tax gifts *inter vivos* that were fully consummated prior to the enactment of subdivision (d) and therefore would be confiscatory under *Nichols v. Coolidge,* 274 U.S. 531, and *Heiner v. Donnan, supra.*

They treat as without significance the power the donor reserved unto himself alone and ground all their arguments upon the fact that deceased, prior to such enactment, completely divested himself of title without power of revocation. It is true that the power reserved was not absolute as in the transfer considered in *Burnet v. Guggenheim, supra,* in which this court, in the absence of any provision corresponding to subdivision (d), held that the donor's termination of the power amounted to a transfer by gift within the meaning of section 319 of the Revenue Act of 1924, 43 Stat. 313. But the reservation here may not be ignored for, while subject to the specified limitation, it made the settlor dominant in respect of other dispositions of both corpus and income. His death terminated that control, ended the possibility of any change by him, and was, in respect of title to the property in question, the source of valuable assurance passing from the dead to the living. That is the event on which Congress based the inclusion of property so transferred in the gross estate as a step in the calculation to ascertain the amount of what in section 301 is called the net estate. Thus was reached what it reasonably might deem a substitute for testamentary disposition. *United States v. Wells,* 283 U.S. 102, 116. There is no doubt as to the power of Congress so to do. *Reinecke v. Northern Trust Co., supra. Chase National Bank v. United States, supra. Tyler v. United States, supra,* 502. *Klein v. United States,* 283 U.S. 231. *Gwinn v. Commissioner,* 287 U.S. 224.

Judgment affirmed.

MR. JUSTICE CARDOZO concurs in the result.

Notes and Problems

(A) Might the question of retroactivity have troubled the Court more than it did? Compare the discussion of this question in *Helvering v. City Bank Farmers Trust Co., supra,* p. 882.

(B) The decedent had created four trusts, one with his wife as beneficiary, and one for each of his three children. He reserved the right to alter or revoke any of the trusts, but only by

directing that the income in each case should be divided equally among the other three beneficiaries. Is any of the property taxable? If so, how much? See *Cook v. Commissioner*, 66 F.2d 995 (C.C.A.3d, 1933), cert. den., 291 U.S. 660 (1934); *Chickering v. Commissioner*, 118 F.2d 254 (C.C.A.1st, 1941), cert. den., 314 U.S. 636 (1941).

(C) Note the provisions of the statute as to powers which are subject to the precedent giving of notice. Is this valid? Is the allowance in such a case of a deduction from the total value of the property for the interest during the required period of notice a constitutionally necessary one?

LOBER v. UNITED STATES

Supreme Court of the United States, 1953. 346 U.S. 335.

MR. JUSTICE BLACK delivered the opinion of the Court.

This is an action for an estate tax refund brought by the executors of the estate of Morris Lober. In 1924 he signed an instrument conveying to himself as trustee money and stocks for the benefit of his young son. In 1929 he executed two other instruments, one for the benefit of a daughter, the other for a second son. The terms of these three instruments were the same. Lober was to handle the funds, invest and reinvest them as he deemed proper. He could accumulate and reinvest the income with the same freedom until his children reached twenty-one years of age. When twenty-one they were to be paid the accumulated income. Lober could hold the principal of each trust until the beneficiary reached twenty-five. In case he died his wife was to be trustee with the same broad powers Lober had conveyed to himself. The trusts were declared to be irrevocable, and as the case reaches us we may assume that the trust instruments gave Lober's children a "vested interest" under state law, so that if they had died after creation of the trusts their interests would have passed to their estates. A crucial term of the trust instruments was that Lober could at any time he saw fit ~~turn~~ all or any part of the principal of the trusts over to his children. Thus he could at ~~will reduce the principal or pay it~~ all to the beneficiaries, thereby terminating any trusteeship over it.

Lober died in 1942. By that time the trust property was valued at more than $125,000. The Internal Revenue Commissioner treated this as Lober's property and included it in his gross estate. That inclusion brought this lawsuit. The Commissioner relied on § 811(d)(2) of the Internal Revenue Code, 26 U.S.C.A. § 811 (1946 ed.). That section, so far as material here, required inclusion in a decedent's gross estate of the value of all property that the decedent had previously transferred by trust "where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . .

to alter, amend, or revoke. . . ." In *Commissioner v. Holmes*, 326 U.S. 480, we held that power to terminate was the equivalent of power to "alter, amend, or revoke" it, and we approved taxation of the Holmes estate on that basis. Relying on the *Holmes* case, the Court of Claims upheld inclusion of these trust properties in Lober's estate. 108 F.Supp. 731. This was done despite the assumption that the trust conveyances gave the Lober children an indefeasible "vested interest" in the properties conveyed. The Fifth Circuit Court of Appeals had reached a contrary result where the circumstances were substantially the same, in *Hayes' Estate v. Commissioner*, 181 F.2d 169, 172–174. Because of this conflict, we granted certiorari. 345 U.S. 969.

Petitioners stress a factual difference between this and the *Holmes* case. The *Holmes* trust instrument provided that if a beneficiary died before expiration of the trust his children succeeded to his interest, but if he died without children, his interest would pass to his brothers or their children. Thus the trustee had power to eliminate a contingency that might have prevented passage of a beneficiary's interest to his heirs. Here we assume that upon death of the Lober beneficiaries their part in the trust estate would, under New York law, pass to their heirs. But we cannot agree that this difference should change the *Holmes* result.

We pointed out in the *Holmes* case that § 811(d)(2) was more concerned with "present economic benefit" than with "technical vesting of title or estates." And the Lober beneficiaries, like the Holmes beneficiaries, were granted no "present right to immediate enjoyment of either income or principal." The trust instrument here gave none of Lober's children full "enjoyment" of the trust property, whether it "vested" in them or not. To get this full enjoyment they had to wait until they reached the age of twenty-five unless their father sooner gave them the money and stocks by terminating the trust under the power of change he kept to the very date of his death. This father could have given property to his children without reserving in himself any power to change the terms as to the date his gift would be wholly effective, but he did not. What we said in the *Holmes* case fits this situation too: "A donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which § 811(d)(2) requires in order to avoid the tax." *Commissioner v. Holmes, supra,* at 487.

Affirmed.

MR. JUSTICE DOUGLAS and MR. JUSTICE JACKSON dissent.

Notes

(A) Sec. 2038 relates to transfers made by the decedent. If he retains a power with respect to the property, it may be taxable under sec. 2038 even though it would not be reached by sec. 2041 relating to powers of appointment. Thus where a person transfers property reserving a special power of appointment, as a power to appoint among his children, the property is taxable under sec. 2038. *Commissioner v. Chase Nat. Bank,* 82 F.2d 157 (C.C.A.2d, 1936), cert. den. 299 U.S. 552 (1936).

Where the trust instrument reserved to the settlor an unqualified right to replace the trustees, and empowered the trustees, with the consent of the adult beneficiaries, to amend the income provisions, it was held that the settlor had retained a power to alter, amend, or revoke the trust within the meaning of § 811(d)(2) of the 1939 Code. *Van Beuren v. McLoughlin,* 262 F.2d 315 (C.A. 1st, 1958).

(B) For discussion of the problems of this section, see Pedrick, "Grantor Powers and Estate Taxation," 54 Northwestern U. L. Rev. 527 (1959). For a consideration of the relation between sec. 2036(a)(2) and sec. 2038, see Leiter, "Estate Tax Consequences of *Inter Vivos* Transfers," 38 Taxes 399 (1960).

7. Annuities

Sec. 2039 of the 1954 Code

The provision with respect to annuities in sec. 2039 of the 1954 Code is entirely new. No corresponding provision was found in any of the previous estate tax laws. The questions which will arise under it remain to be seen. See "Estate Taxation of Survivor Annuities: Section 811(c) and the Proposed IRC of 1954," 6 Stanford L.Rev. 473 (1954); Murphy, "The Survivorship Annuity: Estate Tax Kaleidoscope," 1 Howard L.J. 1 (1955).

Notes

(A) Several cases had arisen under the prior law involving situations where the decedent had purchased an annuity payable to himself for life, and thereafter to another person for that person's life—a so-called joint and survivor annuity. See *Commissioner v. Wilder's Estate,* 118 F.2d 281 (C.C.A.5th, 1941), cert. den. 314 U.S. 634 (1941); *Commissioner v. Clise,* 122 F.2d 998 (C.C.A.9th, 1941), cert. den. 315 U.S. 821 (1942). See, generally, Clark, Taxation of Life Insurance and Annuities 264 (1941).[1]

(B) Note the provisions in sec. 691(d) of the 1954 Code with respect to the income taxation of the annuity received by the survivor, and the deduction of estate tax paid with respect to the annuity.

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1 See also De Carion, "Non-Commercial Annuities and the Federal Gift and Estate Taxes," 9 Tax L.Rev. 61 (1953); Moss, "Estate and Gift Tax Consequences of Intra-Family Annuities, 5 Syracuse L.Rev. 42 (1953).

One of the important provisions of sec. 2039 is that found in sec. 2039(c) under which payments made pursuant to qualified pension plans under sec. 401 (and retirement annuity contracts purchased by charitable organizations) are exempted from the estate tax. Under this provision substantial amounts provided for dependents of an employee may be passed on free of the estate tax, though such benefits are not available to persons who purchase annuity policies themselves, apart from an employer's pension plan.

For general discussion, see Kramer, "Employee Benefits and Federal Estate and Gift Taxes," 1959 Duke L.J. 341; "Estate Taxation of Employee Death Benefits," 66 Yale L.J. 1217 (1957).

8. Jointly Held Property

Sec. 2040 of the 1954 Code

The provision of the statute requiring the inclusion of property held jointly and by the entirety in the gross estate, first appeared as section 202(c) of the Revenue Act of 1916, and has not been substantially changed since. In the 1939 Code, the corresponding provision was sec. 811(e).

UNITED STATES v. JACOBS

Supreme Court of the United States, 1939. 306 U.S. 363.

MR. JUSTICE BLACK delivered the opinion of the Court.

The question is whether the entire value or only one-half the value of real property—purchased by a decedent with his own funds and held at his death by his wife and himself under a joint tenancy set up prior to 1916—may be included in the decedent's gross estate under the 1924 Revenue Act.

In 1909, real estate in Illinois was conveyed to W. Francis Jacobs, the decedent, and Elizabeth C. Jacobs, his wife, "as joint tenants" and this joint tenancy continued until decedent's death; the wife never contributed any part of, or consideration for, the joint property; decedent died June 17, 1924 (after the effective date of the 1924 Revenue Act), and as survivor the wife became sole owner in fee of the whole of the joint property.

The Commissioner included the full value of the property in decedent's gross estate for taxation under the 1924 Act. As executrix, respondent paid the tax, and sought recovery in the District Court which held that the estate tax could be imposed only upon one-half of the joint property's total value. The Circuit Court of Appeals affirmed.

Respondent construes the 1924 Revenue Act as taxing—by its terms—only one-half the value of the joint property, and con-

tends that inclusion of the property's entire value for estate tax purposes would as retroactive taxation violate the Due Process Clause of the Fifth Amendment.

First. It is clear that Congress intended, by Section 302 of the 1924 Act, to include in the gross estate of a decedent the full value at death of all property owned by him and any other in joint tenancy or by the entirety—irrespective of the date of the tenancy's creation—insofar as the property or consideration therefor is traceable to the decedent. Subdivision (h) of Section 302 specifically provided that the provisions of 302 relating to joint tenancies should "apply to the transfers, trusts, estates, interests, rights, powers, and relinquishment of powers, as . . . described therein, whether made, created, arising, existing, exercised, or relinquished *before or after the enactment of this Act.*" (Italics supplied.) Section 302(h) was enacted in the 1924 Act after this Court, on May 1, 1922, had decided that the 1916 Act did not purport to impose an estate tax measured by the value of property held in joint tenancies created prior to the 1916 Act.[1] "The clear language of the 1924 statute repels the notion that it has no application to joint tenancies created prior to September 8, 1916."[2]

Second. Here, decedent paid the entire purchase price of the joint property with his own individual funds and, therefore, the 1924 statute required the inclusion of the full value of the joint property in his gross estate. Contending that the tax as so applied is retroactive, respondent insists that the Due Process Clause of the Fifth Amendment forbids such taxation. The reasoning is that a one-half interest in the joint property was transferred to, and vested in the wife in 1909; that the tax in question only applies to transfers; and that the one-half interest transferred to the wife in 1909 could not thereafter (1924) be taxed as a part of decedent's gross estate without retroactively applying the tax to the 1909 transfer.

But the tax was not levied on the 1909 transfer and was not retroactive. At decedent's death in 1924, ownership and beneficial rights in the property which had existed in both tenants jointly changed into the single ownership of the survivor. This change in ownership, attributable to the special character of joint tenancies, was made the occasion for an excise, to be measured by the value of the property in which the change of ownership occurred. Had the tenancy not been created, this survivorship and change of ownership would not have taken place, but the tax does not operate retroactively merely because some of the

1 Shwab v. Doyle, 258 U.S. 529, 535; Knox v. McElligott, 258 U.S. 546, 549. . . .

2 Gwinn v. Commissioner, 287 U.S. 224, 226; cf., Phillips v. Dime Trust & S. D. Co., 284 U.S. 160, 166.

facts or conditions upon which its application depends came into being prior to the enactment of the tax.

Death duties or excises imposed upon the occasion of change in legal relationships to property brought about by death are ancient in origin. Congress has the power to levy a tax upon the occasion of a joint tenant's acquiring the status of survivor at the death of a co-tenant. In holding that the full value of an estate by the entirety may constitutionally be included in a decedent's gross estate for estate tax purposes, this Court said: "The question . . . is, not whether there has been, in the strict sense of that word, a 'transfer' of the property by the death of the decedent, or a receipt of it by right of succession, but whether the death has brought into being or ripened for the survivor, property rights of such character as to make appropriate the imposition of a tax upon that result (which Congress may call a transfer tax, a death duty or anything else it sees fit), to be measured, in whole or in part, by the value of such rights.

. . .

"At . . . [the co-tenant's] death, however, and because of it, . . . [the survivor] for the first time, became entitled to exclusive possession, use and enjoyment; she ceased to hold the property subject to qualifications imposed by the law relating to tenancy by the entirety, and became entitled to hold and enjoy it absolutely as her own; and then, and then only, she acquired the power, not theretofore possessed, of disposing of the property by an exercise of her sole will. Thus the death of one of the parties to the tenancy became the 'generating source' of important and definite accessions to the property rights of the other. These circumstances, together with the fact, the existence of which the statute requires, that no part of the property originally had belonged to the wife, are sufficient, in our opinion, to make valid the inclusion of the property in the gross estate which forms the primary base for the measurement of the tax." [3]

Thereafter, it was further decided that the full value of the property passing to a survivor under a tenancy by the entirety created prior to the estate tax of 1916 could be included in the gross estate.[4] Congress—it has been held—may also constitutionally apply an estate tax to the whole of a joint tenancy created after the 1916 Act,[5] and to half of a joint tenancy created prior to the 1916 Act, where the decedent alone had furnished consideration for the joint property.[6]

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3 Tyler v. United States, 281 U.S. 497, 503, 504.

4 Third National Bank & Trust Co. v. White, 45 F.2d 911, affirmed 287 U.S. 577; Helvering, Commissioner v. Bowers, 303 U.S. 618.

5 Foster v. Commissioner, 303 U.S. 618.

6 Gwinn v. Commissioner, supra; Griswold v. Helvering, 290 U.S. 56, 58. In the Griswold case this Court said: "Whether this application of the statute gives it a retroactive effect is the sole question here involved; and with

It is urged that these decisions do not support the tax here upon the full value of the joint property, because this tenancy was created prior to the estate tax law of 1916. Respondent relies upon differences in the nature of tenancies by the entirety and joint tenancies in order to remove the present case from the application of these prior adjudications. Since a joint tenant's interest in realty is severable and subject to sale, the argument is that upon the death of a co-tenant the survivor actually receives nothing more than the decedent's one-half interest and therefore no more can be subjected to a death duty. On the other hand, respondent explains the permissible taxation of the whole of a tenancy by the entirety by reference to the "amiable fiction" [7] of the common law, under which ownership of a husband and wife in tenancy by the entirety is deemed a single individual unity and each owns all and every part of the property so held. By virtue of this feudal fiction of complete ownership in each of two persons, the surviving tenant by the entirety is conceived to be the recipient of all the property upon the death of the co-tenant, and therefore—it is said—all the property can be taxed. . . .

While it is true that until the death of decedent here each joint tenant possessed the right to sever the joint tenancy, each was nevertheless subjected to the hazard of losing the complete estate to the other as survivor. Prior to decedent's death, his wife had no right to dispose of her interest by will, nor could it pass to her legal heirs. She might survive and thereby obtain a complete fee to the property with attendant rights of possession and disposition by will or otherwise. Until the death of her co-tenant, the wife could have severed the joint tenancy and thus have escaped the application of the estate tax of which she complains. Upon the death of her co-tenant she for the first time became possessed of the sole right to sell the entire property without risk of loss which might have resulted from partition or separate sale of her interest while decedent lived. There was—at his death—a distinct shifting of economic interest,[8] a decided change for the survivor's benefit. This termination of a joint tenancy marked by a change in the nature of ownership of property was designated by Congress as an appropriate occasion for the imposition of a tax. Neither the amount of the tax nor its application to the survivor's change of status and ownership, was in any manner dependent upon the date of the joint tenancy's creation,

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that we find no difficulty. Under the statute the death of decedent is the event in respect of which the tax is laid. It is the existence of the joint tenancy at that time, and not its creation at an earlier date, which furnishes the basis for the tax."

7 Cf., Tyler v. United States, supra, at 503.

8 Cf. Chase Nat. Bank v. United States, 278 U.S. 327, 338; Saltonstall v. Saltonstall, 276 U.S. 260, 271.

whether before, or after, 1916. It is immaterial that Congress chose to measure the amount of the tax by a percentage of the total value of the property, rather than by a part or by a set sum for each such change. The wisdom both of the tax and of its measurement was for Congress to determine. . . .

The judgment in No. 391 is reversed . . .

MR. JUSTICE STONE took no part in the consideration or decision of these cases.

MR. JUSTICE MCREYNOLDS, MR. JUSTICE BUTLER, and MR. JUSTICE ROBERTS think that the judgment in No. 391 should be affirmed. . . .

Problem and Notes

(A) *H* and *W* acquired property as tenants by the entirety. Part of the cost was paid by *H* in cash, and *H* and *W* jointly signed a mortgage for the balance. When *H* died part of the mortgage had been paid, but there was no evidence as to who made the payments. In determining the tax on *H's* estate, the Commissioner included the entire value of the property (which was greater than the purchase price), less only the amount of the mortgage indebtedness which was unpaid when *H* died. Did *W* furnish any of the consideration for the purchase when she signed the mortgage note? How much, if any, should be excluded from *H's* gross estate on this account? See *Bremer v. Luff,* 7 F.Supp. 148 (N.D.N.Y., 1933), commented on in 48 Harv.L.Rev. 341 (1934), and 44 Yale L.J. 687 (1935); Lowndes and Kramer, Federal Estate and Gift Taxes (1956) 222–223.

(B) In *Harvey v. United States,* 185 F.2d 463 (C.A.7th, 1950), it appeared that a husband had given securities to his wife. She received income on these securities, and also gains on the sale of some of them. All of this income and the gains were contributed by the wife to a joint account, in which there was a substantial balance on the death of the husband. It was held that none of the contributions of the wife from the income on the securities, or capital gains, should be included in the estate of the husband.

(C) The decedent purchased a number of United States Savings bonds with his own funds. He had these issued in co-ownership, in the name of himself *or* another person, thus: John H. Boogher or Edward Bland. In each case, he delivered the bond to the other co-owner. Some of the co-owners cashed their bonds before the decedent died. Others were still held by the co-owners when he died. It was held that the bonds outstanding at the date of the decedent's death were includible in his gross estate at their then redemption value. *Estate of John H. Boogher,* 22 T.C. 1167 (1954); *Estate of Michael A. Doyle,* 32 T.C. 1209 (1959). See also Mim. 5202, 1941–2 Cum.Bull. 241. But see *Silverman v. McGinnes,* 259 F.2d 731 (C.A.3d, 1958), where a completed gift was found.

(D) Suppose a tenant by the entirety or a joint tenant transfers the property with the other tenant to a third person, and the transfer is made in contemplation of death by one of the ten-

ants who later dies. In *Estate of Edward Carnall*, 25 T.C. 654 (1955), and in *Estate of A. Carl Borner*, 25 T.C. 584 (1955), the Tax Court held that only half of the property should be included in the transferor's gross estate even though he contributed all of the joint tenancy. The Commissioner has acquiesced in the *Carnall* decision. 1956–1 Cum.Bull. 3. See Wright, "Transfer of Joint Property in Contemplation of Death," 55 Mich.L.Rev. 1 (1956), and a Note in 66 Yale L.J. 142 (1956).

Community Property

From 1942 until 1948, sec. 811(e) of the 1939 Code included a paragraph (sec. 811(e)(2)) dealing expressly with community property, and subjecting it to tax on a basis which was analogous to the tax on jointly held property. This provision was repealed in 1948, in connection with the enactment of the "marital deduction," and the general settlement of the problem presented to all three taxes in their application to community property. While the provision was in effect, its constitutionality was upheld in *Fernandez v. Wiener*, 326 U.S. 340 (1945), as applied to Louisiana, and in *United States v. Rompel*, 326 U.S. 367 (1945), as applied to Texas. See also *Flournoy v. Wiener*, 321 U.S. 253 (1944).

Apart from this special and short-lived provision—that is, under the law as it now stands—it has consistently been held that only half of the community property was taxable in the husband's estate when he died. See *Wardell v. Blum*, 276 Fed. 226 (C.C.A.9th, 1921), cert. den. 258 U.S. 617 (1922); *Hernandez v. Becker*, 54 F.2d 542 (C.C.A.10th, 1931); *United States v. Goodyear*, 99 F.2d 523 (C.C.A.9th, 1938).

It should be noted that in community property states, half of the community property is taxable in the estate of the spouse who dies first, regardless of who earned or "produced" the property.

This general problem is now handled by the marital deduction allowed by sec. 2056 of the 1954 Code which will be considered in connection with the material on deductions. This represents a change in approach to the problem. Under the provision in effect from 1942 to 1948 (sec. 811(e)(2) of the 1939 Code), the effort was to put community property on a basis substantially like the situation in the common law states. With the enactment of the marital deduction, the effort is to put the common law states on a basis which is fairly comparable to that in the community property states.

9. Appointed Property

Sec. 2041 of the 1954 Code

The first provision taxing appointed property was section 402 (e) of the Revenue Act of 1918, and the language then enacted remained unchanged until 1942. Without this clause, the Su-

preme Court held (under the 1916 Act) that appointed property was not subject to the federal tax. *United States v. Field,* 255 U.S. 257 (1921).

Until 1942, the statute applied only to "property *passing* under a *general* power of appointment *exercised* by the decedent." The statute as it then stood is discussed in Griswold, "Powers of Appointment and the Federal Estate Tax," 52 Harv.L.Rev. 929 (1939). The results reached under that statute provide the background for the present form of the statute which dates from 1951. Prior to that, extensive amendments were made in 1942. These were largely undone by the 1951 provisions.

HELVERING v. GRINNELL

Supreme Court of the United States, 1935. 294 U.S. 153.

MR. JUSTICE SUTHERLAND delivered the opinion of the Court.

In 1876, John O. Stone died a resident of New York. He left a will by which he created for the benefit of his daughter, the decedent, Annie Stone, a trust fund, the income from which was to be paid to her during her life. The will provided that upon her death her share of the estate should go and be applied to such persons and such uses as she might appoint by last will and testament; but in default of such appointment, her share of the estate should go and belong to her children or issue, respectively, by right of representation; or, in default of such issue, to her next of kin. Surviving John O. Stone, were his widow, and three daughters—namely, this decedent, and Ellen J. Stone and Sarah J. Grinnell. These constituted his only heirs at law and next of kin. The widow died many years before the death of Annie Stone. Annie Stone, the decedent, died September 24, 1927, unmarried, without issue, and leaving as her sole next of kin, her two sisters just named. Her will provided "that what property or money I am allowed to dispose of by will under the will of my dear father, the late Dr. John O. Stone, of the city of New York, I give, devise and bequeath in equal shares to my dear sisters Ellen J. Stone and Sarah J. Grinnell, . . ." After the death of Annie Stone, the two sisters in writing renounced their right to receive the property under this paragraph of her will and elected to take the property under the provisions of the will of their father, John O. Stone.

The Commissioner of Internal Revenue declared a tax deficiency of several thousand dollars in the federal estate tax on the estate of Annie Stone, upon the theory that the property derived from the estate of her father was required to be included in her gross estate in virtue of the fact that she had exercised a power of appointment in respect thereof. The Board of Tax Appeals, on

review, sustained the commissioner. The order of the Board of Tax Appeals based on this holding was reversed by the court of appeals, 70 F.2d 705, upon the ground that the property did not *pass* under the exercise of the power; and consequently, an essential condition of section 302 of the act of 1926 was not present.

Sec. 302, c. 37, 44 Stat. 9, 70, 71, provides:

> "Sec. 302. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—. . .
>
> "(f) To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth; . . ."

The crucial words are "property passing under a general power of appointment exercised by the decedent by will." Analysis of this clause discloses three distinct requisites—(1) the existence of a general power of appointment; (2) an exercise of that power by the decedent by will; and (3) the passing of the property in virtue of such exercise. Clearly, the general power existed and was exercised; and this is not disputed. But it is equally clear that no property passed under the power or as a result of its exercise since that result was definitely rejected by the beneficiaries. If they had wholly refused to take the property, it could not well be said that the property had *passed* under the power, for in that event it would not have passed at all. Can it properly be said that because the beneficiaries elected to take the property under a distinct and separate title, the property, nevertheless passed under the power? Plainly enough, we think, the answer must be in the negative.

The contention of the government is that the tax is imposed "upon the power to transmit or the transmission of property by death; the shifting of the economic benefits in property is the real subject of the tax. . . . the property in question passed to the sisters under the general power of appointment exercised by the decedent by will within the meaning of the statute." But this involves the obviously self-destructive conclusion that an unsuccessful attempt to effectuate a thing required by the statute is the same as its consummation. The tax does not fall upon the mere shifting of the economic benefits in property, but upon the shifting of those benefits by a particular method—namely, by their "*passing* under a general power of appointment," and not otherwise. Acceptance of the government's contention would strip the italicized word of all meaning.

The government relies upon *Chase Nat. Bank v. United States,* 278 U.S. 327, and *Tyler v. United States,* 281 U.S. 497. In neither of these cases was the court concerned with the meaning of the act. In the first case (p. 334) the court said the tax was plainly imposed by the explicit language of the statute, and that there was no question as to its construction. The sole question for determination was as to the constitutional validity of the act. The same is true in respect of the second case. Neither case sheds any light upon the question here involved, namely, the meaning and application of the statutory provision.

The court below leaned confidently upon the decision of the New York Court of Appeals in the *Matter of Lansing,* 182 N.Y. 238. That well considered case and this in principle cannot be distinguished. We think the reasoning of the New York court as to the meaning and application of the state law equally applies to the federal statute here in question. There, as here, the contention of the taxing authorities (there under the state act, here under the federal act) was that the appointee named in the will of the donee of the power took her property thereunder and not under the will of the creator of the power, notwithstanding, the property had been given to her by the will of the former subject to the power of appointment. But the state court answered that the power gave the appointee nothing and took nothing away from her; that she had the right of election and could refuse to take under the appointment and still hold the property, since her title without was as good as it was with the power; that she treated the exercise of the power as a mere attempt and not as an effective execution of it; and that it sufficiently appeared that she elected to reject title from that source.

> "Her rights were fixed by the will of her grandfather, and unless changed pursuant to its provisions her estate in expectancy would become an estate in possession upon the death of her mother. . . . Although the power was exercised in form, her title was perfect without it and she derived no benefit from it. The power was to 'dispose of the remainder' and the remainder was not disposed of but continued where it was. The attempt to execute the power was not effective, because it did nothing. The exercise of a power which leaves everything as it was before is a mere form, with no substance."

The opinion, p. 244, points out that the power might have been exercised so as to have left the appointee with no title at all; but that in fact it was exercised so as to leave her the same title that she would have had if the power had not been exercised. The same is true here.

> "An appointee under a power," the court continued, "has the right of election, the same as a grantee under a deed.

> . . . He can accept the title tendered or reject it in his discretion. It cannot be forced upon him against his will. He cannot be compelled to receive additional evidence of title when he does not want it, and does not need it because his title is perfect without it. His consent is necessary before the attempt to exercise the power becomes binding upon him the same as consent is necessary in making a contract or agreement. Declining or refusing to take has the same effect as incapacity to take, as in the case of a devise to a corporation which has no power to hold any more property because the statutory limit has been exceeded. The title is not affected, but remains where it was before."

We granted the writ of certiorari in this case because of an alleged conflict with *Wear v. Commissioner,* 65 F.2d 665, and *Lee v. Commissioner,* 57 F.2d 399. The reasoning and conclusions of those courts and of the court below cannot be reconciled. We are of opinion that, to the extent of the conflict, the view of the former is wrong and that of the court below is right, and we hold accordingly.

Judgment affirmed.

Problems

(A) Does the case necessarily involve a question of "passing"? How far may it be said that the power is not exercised unless it is effectively exercised? Compare *Rogers Estate v. Helvering,* 320 U.S. 410 (1945), and see Paul, Federal Estate and Gift Taxation (Supplement 1946), sec. 9.22. Did the decision in *Matter of Lansing* involve the construction of "passing"?

(B) Was election essential to the result in the Grinnell case? See *Rothensies v. Fidelity-Philadelphia Trust Co.,* 112 F.2d 758 (C.C.A.3d, 1940), noted in 41 Col.L.Rev. 149 (1941). In *Helvering v. Safe Deposit & Trust Co.,* 316 U.S. 56, 65 (1942), it was said that "this Court has clearly recognized, in *Helvering v. Grinnell,* 294 U.S. 153, that events subsequent to the decedent's death, events controlled by his beneficiaries, can determine the inclusion or not of certain assets within the decedent's gross estate under § 302(f)." Is this statement sound?

KERR'S ESTATE v. COMMISSIONER

United States Court of Appeals, Third Circuit, 1949. 174 F.2d 555.

BIGGS, CHIEF JUDGE. Sarah J. Kissam, a resident of New York, the "donor," died in 1918. Under Mrs. Kissam's will Louise V. Kerr, the "decedent," the donor's daughter, had a life estate in and a testamentary power of appointment over the corpus of a trust created by the will. The will provided that in default of appointment by the decedent the corpus should go equally divided to the decedent's two sons. The decedent died on September 19, 1942 resident in New Jersey and by her will exercised the power by

appointing a life estate to her husband, remainders over at his death to her two sons. The decedent's will was admitted to probate in New Jersey on October 1, 1942 and to probate in New York as the will of a non-resident on February 3, 1943. The decedent's husband died in 1943. The sons expressly renounced the appointments to them under their mother's will electing to take under the donor's will. The law of New Jersey or of New York respecting the law of the execution of powers or of renunciations differs in no pertinent respect from the weight of authority throughout the States and need not be detailed here. The Tax Court of the United States held the value of the entire corpus to be includable in the decedent's gross estate. See 9 T.C. 359. The decedent's executors petitioned for review.

It will be observed that the critical date, that of the decedent's death, was September 19, 1942, and that the pertinent statute is Section 811 of the Internal Revenue Code. The respondent contends that the corpus is includable under both subparagraphs (a) and (f) of Section 811. . . . We think it unnecessary to determine whether subparagraph (a) is applicable for we are of the opinion, as was the Tax Court, that tax incidence is created by paragraph (f). In so deciding we are faced, as was the Tax Court (see 9 T.C. at p. 360), "* * * with the difficult question of to what extent *Helvering v. Grinnell,* 294 U.S. 153, has survived *Rogers Estate v. Helvering,* 320 U.S. 410 * * *"

In the *Rogers* case the Supreme Court rejected the state-law approach adhered to in *Grinnell.* The "recondite niceties of property law" and "the crazy-quilt of local formalisms of historic survivals" were said to be matters of indifference to the federal fisc. But the *Rogers* opinion also stated that where the donee of a power "* * * merely echoes the limitations over upon default of appointment he may well be deemed not to have exercised his power, and therefore not to have passed any property under such a power." In other words, if the precise interest passes to the beneficiary by a state-law title it would seem to be of little consequence that the donee of the power also endeavored to give it to the beneficiary by words of gift in a will.

In the case at bar, however, the donee, the decedent, Mrs. Kerr, created new estates by her exercise of the power by her will. She gave a life estate in the corpus to her husband and remainders to her sons. These estates were not identical with those which would have come into being upon the death of the decedent by state law under the will of the donor, Mrs. Kissam. The decedent "exhausted" the power. Property interests in fact passed by the decedent's will and this is what the estate tax hits. As was said in *Rogers* the statute taxes "an exercise of the privilege of

directing the course of property after * * * death." *Cf. Estate of Charlotte D. M. Cardeza,* 5 T.C. 202, and our decision[1] affirming the cited case.

The decision of the Tax Court in the instant case will be affirmed.

The 1942 Amendments to Section 811(f)

The provisions of sec. 811(f) of the 1939 Code were completely rewritten by sec. 403(a) of the Revenue Act of 1942. Many questions arose under these provisions, but the statutory changes never became fully effective. The law was again substantially rewritten in 1951.

Powers of Appointment Act of 1951

The present form of sec. 2041 of the 1954 Code dates back to the Powers of Appointment Act of 1951, approved June 28, 1951, and amending sec. 811(f) of the 1939 Code. The provisions of the 1951 Act were made "effective as if made by section 403 of the Revenue Act of 1942 on the date of its enactment (applicable with respect to estates of decedents dying after October 21, 1942)." Sec. 2(c) of the Powers of Appointment Act of 1951.

This new provision eliminates almost all of the changes made in 1942. Its text should be carefully examined. For a detailed treatment, see Craven, "Powers of Appointment Act of 1951," 65 Harv.L.Rev. 55 (1951).[2]

The regulations under this provision are secs. 20.2041–1 through 20.2041–3 of the Estate Tax Regulations.

The most important change that has resulted from these statutory amendments is that property subject to a general power is now taxable whether the power is exercised or not, *if* the power was created after October 21, 1942. If the power was created before October 22, 1942, the property is not taxable unless the power is exercised, even though the power is a general power.

Note

The decedent had insurance policies which included settlement options, established in 1938. These options gave the beneficiary a power of appointment with respect to the proceeds of the policy. The insured retained the power to change the beneficiary,

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1 See Commissioner v. Estate of Cardeza, 3 Cir., 173 F.2d 19.

2 See also Guterman, "The Powers of Appointment Act," 29 Taxes 631 (1951); Johnson, "Powers of Appointment," 29 Taxes 965 (1951); "Powers of Appointment Act of 1951," 51 Mich.L.Rev. 85 (1952); McCoid, "The Non-General Power of Appointment—A creature of the Powers of Appointment Act of 1951," 7 Vanderbilt L.Rev. 53 (1953); Fleming, "The Use of Powers in Estate Planning," 32 Taxes 24 (1954).

and the right to surrender the policies or to change the methods of payment, until his death, which occurred in 1950. The Treasury ruled that the power of appointment given to the beneficiary was "created" at the time of the insured's death. Rev.Rul. 278, 1953–2 Cum.Bull. 267. But the Tax Court disagrees, and holds that the power was "created" in 1938, so that nothing is included in the estate of the beneficiary, who died in 1956. *Estate of Ernestina Rosenthal,* 34 T.C. —— (1960).

Questions

(A) Is the statute now in satisfactory form? Does it provide a substantial loophole through which large estates may readily pass with a minimum of estate tax liability while retaining substantial power and control over property? Is further amendment desirable or likely? What form should such amendment take?

(B) Would it be desirable to have an estate tax imposed on the termination of any life interest? *Cf.* Mills, "Transfer From Life Tenant to Remainderman in Relation to the Federal Estate Tax," 19 Taxes 195 (1941); Eisenstein, "Powers of Appointment and Estate Taxes," 52 Yale L.J. 296, 552–553 (1943); Eisenstein, "Are We Ready for Estate and Gift Tax Revision?" 23 Taxes 316 (1945).

See also Surrey, "An Introduction to Revision of the Federal Estate and Gift Taxes," 38 Calif.L.Rev. 1 (1950).

10. Life Insurance

Sec. 2042 of the 1954 Code

The provision expressly including life insurance in the gross estate was first enacted as sec. 402(f) of the Revenue Act of 1918. It provided that the gross estate should include the proceeds of "insurance under policies taken out by the decedent upon his own life." This language continued without change until 1942. It has been said that this clause was one of "misleading simplicity." [1]

Until 1942, there was an exclusion of $40,000 for insurance payable to named beneficiaries. The exemption from the estate tax was then $40,000, making an aggregate of $80,000 which could pass free of estate tax if there was at least $40,000 of insurance. When the $40,000 insurance exclusion was eliminated in 1942, the exemption was increased to $60,000, where it has remained ever since.

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[1] The phrase is from Paul, "Life Insurance and the Federal Estate Tax," 52 Harv.L.Rev. 1037 (1939). See also Paul, Federal Estate and Gift Taxation, c. 10 (1942); "Life Insurance and the Federal Estate Tax," 40 Col.L.Rev. 86 (1940); Lowndes, "Tax Avoidance and the Federal Estate Tax," 7 Law and Contemporary Problems 309, 323–325 (1940); Clark, Taxation of Life Insurance and Annuities (1941).

Questions of state taxation are discussed in Nutting, "Life Insurance Proceeds in State Inheritance and Estate Taxation," 26 Iowa L.Rev. 579 (1941). See also Meisenhelder, "Taxation of Annuity Contracts Under Estate and Inheritance Taxes," 39 Mich.L.Rev. 856 (1941).

The first case involving insurance to reach the Supreme Court was *Lewellyn v. Frick,* 268 U.S. 238 (1925), where the policies had been taken out before the 1918 Act, and some had been irrevocably assigned before that Act was passed. There was no clause in the statute making the insurance provision expressly retroactive, and the Court held the statute inapplicable, saying that "the laws are not to be considered as applying to cases which arose before their passage."

The constitutional validity of the tax measured by the proceeds of the policies, as applied to policies taken out in 1922, was sustained in *Chase National Bank v. United States,* 278 U.S. 327 (1929), decided on the same day and in an opinion by the same justice as in the case of *Reinecke v. Northern Trust Co., supra,* p. 878. See also *United States v. Manufacturers National Bank,* —— U.S. —— (1960).

HELVERING v. LE GIERSE

Supreme Court of the United States, 1941. 312 U.S. 531.

MR. JUSTICE MURPHY delivered the opinion of the Court.

Less than a month before her death in 1936, decedent, at the age of 80, executed two contracts with the Connecticut General Life Insurance Co. One was an annuity contract in standard form entitling decedent to annual payments of $589.80 as long as she lived. The consideration stated for this contract was $4,179. The other contract was called a "Single Premium Life Policy—Non Participating" and provided for a payment of $25,000 to decedent's daughter, respondent Le Gierse, at decedent's death. The premium specified was $22,946. Decedent paid the total consideration, $27,125, at the time the contracts were executed. She was not required to pass a physical examination or to answer the questions a woman applicant normally must answer.

The "insurance" policy would not have been issued without the annuity contract, but in all formal respects the two were treated as distinct transactions. Neither contract referred to the other. Independent applications were filed for each. Neither premium was computed with reference to the other. Premium payments were reported separately and entered in different accounts on the company's books. Separate reserves were maintained for insurance and annuities. Each contract was in standard form. The "insurance" policy contained the usual provisions for surrender, assignment, optional modes of settlement, etc.

Upon decedent's death, the face value of the "insurance" contract became payable to respondent Le Gierse, the beneficiary. Thereafter, a federal estate tax return was filed which excluded from decedent's gross estate the proceeds of the "insurance" pol-

icy. The Commissioner notified respondents Bankers Trust Co. and Le Gierse, as executors of decedent's estate, that he proposed to include the proceeds of this policy in the gross estate and to assess a deficiency. Suit in the Board of Tax Appeals followed, and the Commissioner's action was reversed. 39 B.T.A. 1134. The Circuit Court of Appeals affirmed. 110 F.2d 734. . . .

The ultimate question is whether the "insurance" proceeds may be included in decedent's gross estate.

Section 302 of the Revenue Act of 1926 (44 Stat. 9, 70; as amended, 47 Stat. 169, 279; 48 Stat. 680, 752) provides: "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible . . . —(g) To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life." Thus the basic question is whether the amounts received here are amounts "receivable as insurance" within the meaning of § 302(g).

Conventional aids to construction are of little assistance here. Section 302(g) first appeared in identical language in the Revenue Act of 1918 as § 402(f). 40 Stat. 1057, 1098. It has never been changed. None of the acts has ever defined "insurance". Treasury Regulations, interpreting the original provision, stated simply: "The term 'insurance' refers to life insurance of every description, including death benefits paid by fraternal beneficial societies, operating under the lodge system." Treasury Regulations No. 37, 1921 edition, p. 23. This statement has never been amplified. The committee report accompanying the Revenue Act of 1918 merely noted that the provision taxing insurance receivable by the executor clarified existing law, and that the provision taxing insurance in excess of $40,000 receivable by specific beneficiaries was inserted to prevent tax evasion. House Report No. 767, 65th Cong., 2d Sess., p. 22. Subsequent committee reports do not mention § 302(g). Transcripts of committee hearings in 1918 and since are equally uninformative.

Necessarily, then, the language and the apparent purpose of § 302(g) are vitually the only bases for determining what Congress intended to bring within the scope of the phrase "receivable as insurance." In fact, in using the term "insurance" Congress has identified the characteristic that determines what transactions are entitled to the partial exemption of § 302(g).

We think the fair import of subsection (g) is that the amounts must be received as the result of a transaction which involved an actual "insurance risk" at the time the transaction was exe-

cuted. Historically and commonly insurance involves risk-shifting and risk-distributing. That life insurance is desirable from an economic and social standpoint as a device to shift and distribute risk of loss from premature death is unquestionable. That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators. See for example: *Ritter v. Mutual Life Ins. Co.,* 169 U.S. 139; *In re Walsh,* 19 F.Supp. 567; *Guaranty Trust Co. v. Commissioner,* 16 B.T.A. 314; *Ackerman v. Commissioner,* 15 B.T.A. 635; Couch, Cyclopedia of Insurance, Vol. I, § 61; Vance, Insurance, §§ 1–3; Cooley, Briefs on Insurance, 2d edition, Vol. I, p. 114; Huebner, Life Insurance, Ch. 1. Accordingly, it is logical to assume that when Congress used the words "receivable as insurance" in § 302(g), it contemplated amounts received pursuant to a transaction possessing these features. *Commissioner v. Keller, supra; Helvering v. Tyler, supra; Old Colony Trust Co. v. Commissioner,* 102 F.2d 380; *Ackerman v. Commissioner, supra.*

Analysis of the apparent purpose of the partial exemption granted in § 302(g) strengthens the assumption that Congress used the word "insurance" in its commonly accepted sense. Implicit in this provision is acknowledgement of the fact that usually insurance payable to specific beneficiaries is designed to shift to a group of individuals the risk of premature death of the one upon whom the beneficiaries are dependent for support. Indeed, the pith of the exemption is particular protection of contracts and their proceeds intended to guard against just such a risk. See *Commissioner v. Keller, supra; United States Trust Co. v. Sears,* 29 F.Supp. 643; Hughes, Federal Death Tax, p. 91; Comment, 38 Mich.L.Rev. 526, 528; compare *Chase National Bank v. United States,* 28 F.Supp. 947; *In re Walsh, supra; Moskowitz v. Davis,* 68 F.2d 818. Hence, the next question is whether the transaction in suit in fact involved an "insurance risk" as outlined above.

We cannot find such an insurance risk in the contracts between decedent and the insurance company.

The two contracts must be considered together. To say they are distinct transactions is to ignore actuality, for it is conceded on all sides and was found as a fact by the Board of Tax Appeals that the "insurance" policy would not have been issued without the annuity contract. Failure, even studious failure, in one contract to refer to the other cannot be controlling. Moreover, authority for such consideration is not wanting, however unrealistic the distinction between form and substance may be. *Commissioner v. Keller, supra; Helvering v. Tyler, supra.* See Williston, Contracts, Vol. III, § 628; Paul, Studies in Federal Taxation, 2d series, p. 218; compare *Pearson v. McGraw,* 308 U.S. 313.

Considered together, the contracts wholly fail to spell out any element of insurance risk. It is true that the "insurance" contract looks like an insurance policy, contains all the usual provisions of one, and could have been assigned or surrendered without the annuity. Certainly the mere presence of the customary provisions does not create risk, and the fact that the policy could have been assigned is immaterial since no matter who held the policy and the annuity, the two contracts, relating to the life of the one to whom they were originally issued, still counteracted each other. It may well be true that if enough people of decedent's age wanted such a policy it would be issued without the annuity, or that if the instant policy had been surrendered a risk would have arisen. In either event the essential relation between the two parties would be different from what it is here. The fact remains that annuity and insurance are opposites; in this combination the one neutralizes the risk customarily inherent in the other. From the company's view-point, insurance looks to longevity, annuity to transiency. See *Commissioner v. Keller, supra; Helvering v. Tyler, supra; Old Colony Trust Co. v. Commissioner, supra; Carroll v. Equitable Life Assur. Soc.,* 9 F.Supp. 223; Note, 49 Yale L.J. 946; Cohen, Annuities and Transfer Taxes, 7 Kan.B.A.J. 139.

Here the total consideration was prepaid and exceeded the face value of the "insurance" policy. The excess financed loading and other incidental charges. Any risk that the prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk as explained above. It follows that the sums payable to a specific beneficiary here are not within the scope of § 302(g). The only remaining question is whether they are taxable.

We hold that they are taxable under § 302(c) of the Revenue Act of 1926, as amended, as a transfer to take effect in possession or enjoyment at or after death. See *Helvering v. Tyler, supra; Old Colony Trust Co. v. Commissioner, supra; Kernochan v. United States,* 29 F.Supp. 860; *Guaranty Trust Co. v. Commissioner, supra;* compare, *Gaither v. Miles,* 268 F. 692; Comment, 38 Mich.L.Rev. 526; Comment, 32 Ill.L.Rev. 223.

The judgment of the Circuit Court of Appeals is reversed.

THE CHIEF JUSTICE and MR. JUSTICE ROBERTS think the judgment should be affirmed for the reasons stated in the opinion of the Circuit Court of Appeals.

Note

Compare the result in *Fidelity-Philadelphia Trust Co. v. Smith,* 356 U.S. 274 (1958), stated at p. 856(D), above, where the facts were similar except that the decedent gave away the insurance policies shortly after they were issued, and not in contemplation of death. She retained the annuity policy. It was held that nothing was taxable in her gross estate under either of the provisions now found in secs. 2036 and 2037.

What was the meaning of "taken out by the decedent on his own life"? The Treasury at various times used one or the other of two tests: (1) "payment of the premiums," or (2) "incidents of ownership," as illustrated by the following case:

LANG v. COMMISSIONER

Supreme Court of the United States, 1938. 304 U.S. 264.

MR. JUSTICE MCREYNOLDS delivered the opinion of the Court.

The Circuit Court of Appeals has certified propositions of law concerning which instructions are desired for decision of a pending cause. U.S.C., Title 28, sec. 346.

In 1905 Julius C. Lang married in the State of Washington, where community property laws have long obtained, and both parties continued to be domiciled there until he died in 1929. At his death seventeen policies of insurance upon his life—totaling above $200,000.00—were in force. Each policy required advanced payment of one premium. Fourteen specified the wife as sole beneficiary; children were the beneficiaries in three. Three of those payable to the wife were obtained by the assured prior to marriage and early premium payments upon them came from his separate property; later ones from community funds. Application for fourteen policies followed the marriage and all premiums thereon were paid from community funds.

The Commissioner of Internal Revenue ruled that under section 302(g), Revenue Act 1926, c. 27, 44 Stat. 9, the entire proceeds from all policies should be reckoned as part of the assured's gross estate subject to the permitted exemption of $40,000, and made an assessment accordingly. The Board of Tax Appeals affirmed.

The exemption is not controverted and by admission each policy permitted the assured to change the beneficiary. The point for consideration is whether all or any portion of the proceeds of a policy, premiums on which were paid out of community funds, must be treated as part of the decedent's gross estate.

1. Must the total or only one-half of the proceeds collected under the insurance policies issued after marriage on the deceased husband's life be reckoned as part of his gross estate, the wife being sole beneficiary and all premiums having been paid from community funds? To this we answer, only one-half.

2. Must the total proceeds of the policy upon a decedent's life, taken out after marriage, children being the sole beneficiaries, and all premiums having been paid from community funds, be reckoned as part of his gross estate; or, in the circumstances, is only one-half to be included? To this we reply, only one-half should be included.

3. Must all proceeds of the policies issued before marriage upon the deceased husband's life be reckoned as part of his gross estate, the wife being sole beneficiary, the first premium having been paid from his separate funds, and all subsequent ones from community funds; or, in the circumstances, is the total received under the policy reduced by one-half of that proportion of such total which premiums satisfied with community funds bear to all premiums paid, the amount to be regarded as belonging to the gross estate? To this we reply, only the total proceeds less one-half of the indicated proportion becomes part of the gross estate.

Section 301, Revenue Act 1926, *supra,* imposes a tax upon the transfer of the net estate of every decedent, etc. And section 302 provides—

> "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—[(a), (b), (c), (d), (e), (f).]
>
> "(g) To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life."

The Revenue Acts of 1918, 1921 and 1924 contain similar provisions relative to "policies taken out by the decedent upon his own life."

Treasury Regulations 37 promulgated under the Revenue Act of 1918 provide—

> "Art 32. . . . The term 'insurance' refers to life insurance of every description . . . Insurance is deemed to be taken out by the decedent in all cases where he pays the premiums, either directly or indirectly, whether or not he makes the application. On the other hand, the insurance should not be included in the gross estate, even though the application is made by the decedent, where the premiums

are actually paid by some other person or corporation, and not out of funds belonging to, or advanced by, the decedent. . . ."

And there are similar provisions in Treasury Regulations 63, Art. 27, promulgated under 1921 Revenue Act.

Treasury Regulations 68 promulgated under the Revenue Act 1924—

> "Art. 25. . . .
>
> "The term 'insurance' refers to life insurance of every description . . . Insurance is deemed to be taken out by the decedent in all cases where he pays all the premiums, either directly or indirectly, whether or not he makes the application. On the other hand, the insurance is not deemed to be taken out by the decedent, even though the application is made by him, where all the premiums are actually paid by the beneficiary. Where a portion of the premiums were paid by the beneficiary and the remaining portion by the decedent the insurance will be deemed to have been taken out by the latter in the proportion that the premiums paid by him bear to the total of premiums paid."
>
> "Art. 28. The amount to be returned where the policy is payable to or for the benefit of the estate is the amount receivable. Where the proceeds of a policy are payable to a beneficiary other than to or for the benefit of the estate, and all the premiums were paid by the decedent, the amount to be listed on Schedule C of the return is the full amount receivable, but where the proceeds are so payable and only a portion of the premiums were paid by the decedent, the amount to be listed on such schedule is that proportion of the insurance receivable which the premiums paid by the decedent bears to the total premiums paid. . . ."

Arts. 25 and 28, Treasury Regulations 70, promulgated under Revenue Act 1926, contain provisions identical with those just quoted.

Treasury Regulations 70 were in force when Lang died and are applicable to his estate. It is unnecessary for us to consider the meaning, validity or effect of the changes introduced by Regulations 80.[1]

Articles 25 and 28 of Regulations 70 defines the words "policies taken out by the decedent upon his own life." Earlier regulations gave the same definition. Nothing else appearing, it must be treated as approved by Congress. *Helvering v. Bliss,* 293 U.S. 144, 151. Counsel for the Commissioner suggest that it is

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1 It was this Regulation which adopted the "incidents of ownership" test. It was promulgated after the death of the decedent in the Lang case, and was thus not applicable there. [Ed.]

at variance with the statute, unreasonable and without effect; but we think this objection is clearly untenable.

Under the community property statutes of Washington, as interpreted below, one-half of the amounts of the community funds applied to payment of premiums was property of the wife. To that extent she paid these premiums. Where she is the beneficiary, under the words of the Regulations she became entitled to the proceeds of the policy in proportion to the amount so paid.

Where children were named beneficiaries and premiums were paid from community funds the situation is not within the precise words of the Regulations; but the rather obvious reason underlying the definition of what constitutes a policy "taken out by the assured" should be respected. In the absence of a clear declaration it cannot be assumed that Congress intended insurance bought and paid for with the funds of another than the insured and not payable to the latter's estate, should be reckoned as part of such estate for purposes of taxation. See *Igleheart v. Com'r,* 77 F.2d 704, 711.

Notes

(A) See Thurman, "Federal Estate and Gift Taxation of Community Property Life Insurance," 9 Stanford L.Rev. 239 (1957), also in 35 Taxes 597 (1957).

(B) When the wife dies first, and there is insurance on the husband's life, paid for out of community funds, half of the cash surrender value is includible in her gross estate, as property owned by her, under sec. 2033. *United States v. Stewart,* 270 F.2d 894 (C.A.9th, 1959). See sec. 20.2042–1(c)(5) of the Estate Tax Regulations.

The 1942 Amendment

On January 10, 1941, the Treasury issued T.D. 5032, 1941–1 Cum.Bull. 427, by which it was provided that insurance would be taxable (1) to the extent that the decedent had paid the premiums after January 10, 1941, and (2) to the extent that the decedent had incidents of ownership with respect to insurance taken out before or after that date. See "Federal Estate Taxation of Life Insurance," 40 Mich.L.Rev. 1221 (1942); Wells, "T.D. 5032 and the Lang Case," 20 Taxes 86 (1942).

In 1942, sec. 811(g) of the 1939 Code was amended so as to make the statute read that insurance is taxable where the decedent *either* paid the premiums *or* had incidents of ownership.

The statute remained in this form until the enactment of the 1954 Code.[1] It was also expressly provided that "the term 'incident of ownership' does not include a reversionary interest."

The 1954 Amendment

In sec. 2042 of the 1954 Code, the payment of the premiums test was eliminated. Under that provision, insurance payable to named beneficiaries is taxable only when the insured retained incidents of ownership.[2] A reversionary interest is now defined as being an "incident of ownership" when its value is more than 5% of the value of the policy just before the death of the insured.

It has been argued that this change merely puts insurance on a par with other property, which is not taxable in the decedent's estate if he retained no interest in it? Is this a sound argument? Could a distinction be drawn between (1) the value of the policy immediately before the decedent's death, as to which he retained no ownership, and (2) the increment in value resulting from the decedent's death, and which could not be obtained by the beneficiary-owner of the policy until the insured died? Note that as to the latter element (1) no gift tax is paid, (2) no income tax is paid (under sec. 101(a)(1) of the 1954 Code), and (3) no estate tax is paid under sec. 2042. Is this sound?

Is there an element of truth in both approaches? Would it be desirable to provide that insurance given away before death (and not in contemplation of death) would not be taxable to the extent of the cash value of the policy owned by the beneficiary just before the decedent's death but would be taxable as to the increment in value resulting from the decedent's death and not theretofore obtainable by him? Cf. Schlesinger, "Taxes and Insurance: A Suggested Solution to the Uncertain Cost of Dying," 55 Harv.L.Rev. 226 (1941).

Notes and Problems

(A) Suppose a wife takes out insurance on her husband's life. She pays all the premiums, and he has no incidents of ownership. Is anything taxable on his death? What is the situation on her death?

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1 For discussions, see Murphy, "Life Insurance—Slave or Master of Section 811(g)?" 7 Tax L.Rev. 131 (1952); Menard, "Life Insurance and the Federal Estate Tax," 27 N.C.L.Rev. 43 (1948); Waldo, "Life Insurance and Estate Planning," 1949 U. of Ill.L.Forum 95.

2 See Brown, "How the Premium Payment Test Affects Small Business," 36 Taxes 295 (1958); Brown, "Facts of the Life Insurance Premium Payment Test," 34 Taxes 727 (1956); "Elimination of the 'Premium Payment' Test in the Estate Taxation of Life Insurance Proceeds," 41 A.B.A.J. 174 (1955). See also "Estate Taxation of Employee Death Benefits," 66 Yale L.J. 1217 (1957).

Suppose husband and wife each bought insurance on the life of the other.

See Hodge, "Life Insurance and the Estate Tax," 25 Taxes 352 (1947); Fink, "Insurance Not Includable in the Insured's Estate," 25 Taxes 997 (1947).

(B) From time to time the proposal is made that the proceeds of life insurance to the extent needed to pay estate tax should be exempt from, or deductible in computing, estate tax. Is this a sound or desirable suggestion? See Harriss, "Proposals to Exempt Life Insurance Used to Pay Estate Tax," 5 Tax L.Rev. 119 (1950).

Compare the provision of sec. 303 of the 1954 Code, allowing (in certain cases) the redemption of stock to pay death taxes, at capital gain rates, and free from tax as an ordinary dividend. See the references to this provision at page 688, above.

(C) The decedent applied for life insurance. A law partnership of which he was a member (and in which his percentage of the profits was 42.34 per cent) paid the premiums in compliance with the partnership agreement that the proceeds would be accepted by the beneficiary, the decedent's wife, in lieu of the decedent's interest in the firm. The decedent retained the right to change the beneficiary. On his death, his executor contended that only 42.34 per cent of the proceeds should be included in the gross estate. Was this sound under the law then in effect? *Dobrzensky v. Commissioner,* 34 B.T.A. 305 (1936). Suppose the insurance had been payable to the firm, and there had been an agreement or arrangement that the firm would use the proceeds to pay the decedent's estate for his interest in the firm.[3]

(D) The M Company has a death benefit plan, applicable to employees who have been in the company's employ for one year or more at the time of death. The employee may designate the beneficiary. The amount payable depends on the amount of pay and length of service of the employee. The company reserves the right to withdraw the plan at any time, but agrees to make payment in accordance with the plan as it may be in effect at the time of an employee's death. An employee dies, and the company makes payment to the beneficiary he had designated. Should the amount so paid be included in the employee's gross estate under sec. 2042, or under any other provision? See also sec. 2039(c) of the 1954 Code.

[3] On the general question, see Swados, "Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement," 26 Fordham L.Rev. 189 (1957); Manheimer and Friedman, "Stock Retirement Agreements—The Prunier and Sanders Cases," 35 Taxes 567 (1957); Appleman, "A New Approach to Buy and Sell Agreements," 30 Taxes 821 (1952); "Estate Tax Effects of Partners' Cross-Insurance and Purchase-Sale Agreements," 48 Col.L.Rev. 450 (1948); Matthews, "Estate Tax Consequences of Agreements for the Sale of a Partnership Interest Effective at the Partner's Death," 26 Tex.L.Rev. 729 (1948); Forster, "Legal, Tax and Practical Problems Under Partnership Purchase and Sale Agreements Coupled with Life Insurance," 19 So.Calif.L.Rev. 1 (1945).

C. VALUATION

See **Secs. 2031(b) and 2032** of the 1954 Code

LAIRD v. COMMISSIONER

United States Circuit Court of Appeals, Third Circuit, 1936. 85 F.2d 598.

DAVIS, CIRCUIT JUDGE.[4] This case is before us on petition for rehearing. In our prior decision we affirm the order of redetermination of the Board of Tax Appeals holding the petitioners-appellants liable for a deficiency in taxes under the estate tax provisions of the Revenue Act of 1926. But since the decision was rendered in this case, the decision in *Helvering v. Taylor,* 293 U.S. 507, was handed down, and therefore the appellants filed a petition for rehearing.

The facts briefly restated are as follows: William Winder Laird died on November 9, 1927. At his death he owned 1,000 shares of common stock in the Christiana Securities Company and 250 shares in the Delaware Realty & Investment Company. In his tax return under the estate tax provisions, the stock of the Christiana Company was valued at $800 per share and the stock of the Delaware Company at $781.17 per share. The Commissioner did not accept that valuation, and revalued the stock of the Christiana Company at $1,760.60 per share, and that of the Delaware Company at $15,066.51 per share. The petitioners appealed to the Board, which sustained the Commissioner, and they then appealed from the determination of the Board to this court.

The question involved in this case is whether or not the determination of the Commissioner was made in accordance with the applicable statutory provisions and treasury regulations.

The Christiana Company and the Delaware Company are both close corporations. Their stock has never been listed or dealt in on any stock exchange or market. The principal assets of the Christiana Company consisted of 840,000 shares of E. I. du Pont de Nemours & Company, and 70,571 shares of the Atlas Powder Company. The Delaware Company also held large blocks of stock in these two companies, and also a considerable amount of stock in the Hercules Powder Company.

Section 302 of the Revenue Act of 1926 provides that:

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

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4 Only the opinion on rehearing is printed.

"(a) To the extent of the interest therein of the decedent at the time of his death."

Treasury Regulations 70, art. XII, promulgated under this act, provides that:

"The value of all property includable in the gross estate is the fair market value thereof at the time of the decedent's death. The fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell. . . .

"(3) Stocks and bonds—The value of stocks and bonds listed upon a stock exchange should be determined by taking the mean between the highest and lowest quoted selling prices upon the date of death. . . .

"Stock in a close corporation should be valued upon the basis of the company's net worth, earning and dividend-paying capacity, and all other factors having a bearing upon the value of the stock. . . ."

The method employed by the Commissioner in determining the value of the stock held by both the Christiana and the Delaware Companies was that provided for corporations whose stocks and bonds are bought and sold in the open market on stock exchanges. The result in substance was the application of this method to the stock of these close corporations. The Board describes the method used by the respondent in redetermining the value of the stock in these two corporations as follows:

"There have never been any sales establishing the market value of them. In the absence of such sales the respondent valued the assets of each company, consisting principally of listed stocks, and divided the net worth of each company by the number of shares outstanding for the purpose of arriving at the value of each share. . . .

"In valuing the shares of stock owned by these family corporations, the respondent used the median between the high and low points at which these shares of stock sold on the stock exchanges on the date of death of the decedent, viz., November 19, 1927."

This not only ignored the treasury regulations prescribing the method by which stock in close corporations should be valued, but directly violated these regulations. Stock in such a corporation must not be valued "by taking the mean between the highest and lowest quoted selling prices" of the stock constituting the assets of the corporation to determine the worth of the company and then dividing this by the number of shares outstanding. That would be doing indirectly what may not be done directly. The stock in these two close corporations could not have been sold on the day of Mr. Laird's death, for no one could have forced the sale of all the stock constituting the assets of the Christiana and the Delaware Companies. At least, the executor of Mr.

Laird's estate could not have done it. Even if it could have been done and all this stock had been dumped on the market on a single day, the testimony was that it would have driven the price of the du Pont stock down from $325 to $125 per share. That of course was a guess, but it shows that the method which the Board used was impractical when applied to the determination of the value of the assets of close corporations which consist entirely of stock listed on stock exchanges, for it results in the application of that method to the stock of close corporations themselves. It is common knowledge that the price at which stocks sold in 1927, 1928, and 1929 did not at all reflect their true worth. The earning and dividend-paying capacity of many stocks during that period was less than one per cent. per annum of their selling price. It is for this reason that in a close corporation in which there is no sale for the stock, the treasury regulations will not permit the Commissioner or Board to take the mean between the highest and the lowest selling prices of a comparatively small number of the shares of the stock which constitutes the entire asset of the corporation, apply this price to the shares of stock, and thus find their speculative value and assess accordingly. Such stock must be based upon the company's worth, its earning and dividend-paying capacity, and all other factors which have a bearing upon the stock, one of which might be the mean value of the selling price on a particular day of the stock which it owns. Neither the Commissioner nor the Board gave any consideration whatever to the earning and dividend-paying capacity of the Christiana and Delaware stock. Their method was arbitrary and contrary to the regulations. This is all that it is necessary for the taxpayer to show in order to have the case remanded to the Board of Tax Appeals for further proceedings. *Helvering v. Taylor,* 293 U.S. 507.

The case will be remanded to the Board for further proceedings in accordance with the treasury regulations in redetermining the value of the stock in question.

Notes and Problems

(A) There are few problems in law or economics where the criteria are more uncertain than in questions of value. See Bonbright, The Valuation of Property (1937). *Cf.* Judge Frank's remarks in *Andrews v. Commissioner,* 135 F.2d 314, 317 (C.C.A. 2d, 1943). Such questions frequently arise in estate tax cases where securities or real estate have to be evaluated. Often, with much negotiation, and a good deal of give and take, it is possible to come to a reasonable adjustment on this issue with the revenue authorities.

The Treasury's views on valuation are fully and helpfully stated in Rev.Rul. 59–60, 1959–1 Cum.Bull. 237. See also Stuetzer, "Valuing Business Interests of a Decedent (Close Corporation, Contracts, Blockage) The Implication of Revenue Ruling 59–60,"

N.Y.U. 18th Ann. Inst. on Fed. Taxation 1185 (1960); Lowndes and Kramer, Federal Estate and Gift Taxes (1956) 454–540.[1]

Life Interests and Remainders

(B) The regulations provide tables for the valuation of life and similar interests. For many years these were based on 4% interest, and the Actuaries' or Combined Experience Table of Mortality. See sec. 81.10 of Regulations 105. This table was prepared in Great Britain in 1843. In 1952, after considerable controversy, the Treasury adopted new valuation tables for determining the value of life estates and annuities, effective with respect to transfers made on and after January 1, 1952. The new tables are based on a 3½% interest rate, and the United States Life Tables published by the Department of Commerce. They are now found in sec. 20.2031–7 of the Estate Tax Regulations.[2]

"Blockage"

(C) The decedent's estate included a block of 30,000 shares of a particular stock. These shares sold on the market on the date of the decedent's death at $10 a share. Should this price per share be used in valuing the block of shares left by the decedent? See *Commissioner v. Shattuck,* 97 F.2d 790 (C.C.A.7th, 1938). The Treasury long opposed any recognition of "blockage" as an element in valuation, but it lost consistently in the courts. *Cf. Maytag v. Commissioner,* 187 F.2d 962 (C.A.10th, 1951). Its ruling now provides that "The size of the block of stock itself is a relevant factor to be considered." Rev.Rul. 59–60, 1959–1 Cum.Bull. 237, 242.[3]

Are there circumstances in which a block of shares might be worth more than the indicated price per share? See Peters, "The Fair Market Value of Blocks of Stock," 17 Taxes 17 (1939).

Restrictive Agreements

(D) The decedent died leaving Blackacre worth $10,000 on the open market, but some time previous to his death, when Blackacre was worth $8,000, the decedent had given an option to sell the land for $8,000, and this option was outstanding when the

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1 See also Maney, "Valuation of Common Stock of Unlisted Corporations," 33 Taxes 584 (1955); Rockefeller, "Valuation of Closely Held Stocks for Estate and Gift Tax Purposes," 36 Taxes 244 (1958); Rice, "The Valuation of Close Held Stocks: A Lottery in Federal Taxation," 98 U. of Pa.L.Rev. 367 (1950); Rockefeller, "Federal Estate Tax Valuation of Family Corporation Stocks," 28 Taxes 1031 (1950); Davies, "The Valuation of Good Will," 31 Neb.L.Rev. 559 (1952); Gordon, "Proof of Value by Opinion Evidence in Tax Court Trials," 3 Utah L.Rev. 9 (1952); Gordon, "What Is Fair Market Value?" 8 Tax L.Rev. 35 (1952); Sprecher, "The Valuation of Stock in a Closely-held Corporation for Federal Gift and Estate Tax Purposes," 31 Ky.L.Rev. 325 (1943); "Valuation of Corporate Stock for Inheritance and Estate Taxation," 26 Iowa L.Rev. 674 (1941).

2 On the general question of valuations involving life contingencies, see Wolfe and Corcoran, Inheritance Tax Calculations (2d ed. 1937).

3 See Hughes, "'Blockage' in Valuation of Assets for Federal Tax Purposes," 25 Fordham L.Rev. 702 (1957); Grunewald, "An Old Formula in New Attire," 11 Tax L.Rev. 190 (1956); Barrett, "Valuation of Stocks by the Blockage Rule," 29 Taxes 465 (1951).

decedent died. At what value should Blackacre be included in his gross estate? *Cf. Helvering v. Salvage,* 297 U.S. 106, 109 (1936): "Considering the option to repurchase at par, outstanding in 1922, there could be no proper finding of fair market value at that time in excess of $100 per share."

In *May v. McGowan,* 194 F.2d 396 (C.A.2d, 1952), the two shareholders in a corporation entered into agreements giving the survivor an option to buy the stock of one who died at a price to be computed by a formula which took into account certain indebtedness of the corporation assumed by one of the shareholders. One died, and under the formula the other became entitled to acquire the stock at a zero cost. It was held that the stock should be valued at zero for estate tax purposes. See Pavenstedt, "The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements to Control Estate Tax Valuation," 51 Mich.L.Rev. 1 (1952).

Would it be different if the restriction was imposed by the decedent's will? See *Estate of Nieman,* 230 Wis. 23, 283 N.W. 452 (1939), where the testator left a controlling interest in stock in a newspaper, and directed that it be sold, not necessarily to the highest bidder, but to such persons as "would carry out the ideals and principles" maintained by the testator. The trustees sold the stock to one group for less than they could have obtained from another.

Most of the cases involving this sort of question have arisen out of corporate by-laws or restrictive agreements requiring that stock be offered to the corporation or to other shareholders at a specified price before it can be sold to an outsider. The cases are extensively reviewed in *Spitzer v. Commissioner,* 153 F.2d 967 (C.C.A.8th, 1946). See also *Worcester County Trust Co. v. Commissioner,* 134 F.2d 578, 581–582 (C.C.A.1st, 1943). *Cf. Commissioners of Inland Revenue v. Crossman,* [1937] A.C. 26, and the notes in 178 L.T. 83 (1934); 1 Sol. 145 (1934). See Lowndes and Kramer, Federal Estate and Gift Taxes (1956) 533–540; Rev.Rul. 59–60, 1959–1 Cum.Bull. 237, 243–244; "Effect of Stock Purchase Agreements on Death Tax Valuation," 41 Marquette L.Rev. 48 (1957).[4] The general problem is discussed in Molloy, "Restraints on Alienation and the Internal Revenue Code," 7 Tax L.Rev. 439 (1952).

Alternate Valuation Date

Sec. 2032 of the 1954 Code

Unless an election is made under sec. 2032, the property included in the gross estate is included at its value at the date of the decedent's death. In some cases this was thought to present a serious hardship, as where the decedent dies during or just before a period of market decline. In such a situation, the value

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[4] See also Ness, "Federal Estate Tax Consequences of Agreements and Options to Purchase Stock on Death," 49 Col.L.Rev. 796 (1949); "Valuation of Stock Subject to Restrictive Agreement for Federal Estate and Gift Taxes," 60 Harv.L.Rev. 123 (1946); "Valuation of Restricted Shares for Tax Purposes," 90 U. of Pa.L.Rev. 346 (1941).

of the property left by the decedent may have declined sharply before the executor can gather it in and realize upon it. In the depression years of the 1930's there were some cases where the amount of taxes due (on the valuation at the date of death) was in excess of the amount which the executor was able to realize out of the property.

In order to deal with this situation, Congress in 1935 added the alternate valuation date provision now found in sec. 2032 of the 1954 Code. (In the previous statutes this was known as the "optional valuation date.") Under this, the executor has the option of using the value at the date of death, or the value one year after death (or at the earlier date on which the property is disposed of). This provision should be carefully examined.

The option must be exercised as to all of the property in the gross estate or as to none of it. It cannot be exercised as to some items of the property and not as to other items.

Notes

(A) See "Optional Valuation Date under the Federal Estate Tax," 52 Harv.L.Rev. 1157 (1939); Lowndes and Kramer, Federal Estate and Gift Taxes (1956) 457–465. The alternate valuation date is available only when an election is made in a return which is filed within the time prescribed by law (including a valid extension of the filing period). See sec. 2032(c) of the 1954 Code; sec. 20.2032–1(b) of the Estate Tax Regulations; *Estate of Henry S. Downe,* 2 T.C. 967 (1943). See also Rev.Rul. 54–445, 1954–2 Cum.Bull. 301. *Cf. William Howard Doriss,* 3 T.C. 219 (1944), where the return, on the last day, reached a truck in the post office which was reserved for the Collector's mail. This was held to be sufficient to constitute filing with the Collector.

(B) How far may events occurring after death be taken into account in determining the value on the optional valuation date? In *Estate of John A. Hance,* 18 T.C. 499 (1952), the decedent and his wife were joint annuitants under an annuity purchased by the decedent. The decedent died; and his wife died less than one year later. It was held that the wife's death could be taken into account in valuing the annuity at the optional valuation date.

(C) Shortly after the optional valuation date was introduced, the Treasury confronted this problem: A decedent died leaving a large block of stock in his family company. After his death the company declared a large dividend. This reduced the value of the stock, and the executors then elected the optional valuation date for estate tax purposes. Thus, an income tax was paid, but estate tax was saved.

The Treasury sought to deal with this by a Regulation (Art. 11 of Regulations 80 (1937) Ed.)), by which it ruled in substance that if the optional valuation date is elected, interest or dividends received after the decedent's death must be included in the valuation. The Treasury sought to apply this regulation to all income

received after death and before the optional valuation date. As so applied, the regulation was held invalid in *Maas v. Higgins,* 312 U.S. 443 (1941).

(D) The Treasury's views with respect to situations where stock rights, stock dividends, insurance proceeds, or mortgage payments are received or disposed of within the year following death are stated in Rev.Rul. 58–576, 1958–2 Cum.Bull. 576.

D. DEDUCTIONS

Secs. 2052–2056 of the 1954 Code

1. The Exemption

Sec. 2052 of the 1954 Code

The deduction provided in sec. 2052 of the 1954 Code is $60,000. This represents no change from the prior law. Under sec. 812(a) of the 1939 Code, the exemption stated was $100,000. This was of importance, however, only in the calculation of the part of the tax which was within the 80 per cent credit provision (see p. 949, below). By section 935(c) of the 1939 Code the exemption used in computing the additional estate tax was $60,000. The same effect is now reached under sec. 2011 of the 1954 Code.

2. Debts, Claims and Administration Expenses

Sec. 2053 of the 1954 Code

DU VAL'S ESTATE v. COMMISSIONER

United States Circuit Court of Appeals, Ninth Circuit, 1945. 152 F.2d 103.

ORR, CIRCUIT JUDGE. This is a petition by the executors of the last will and testament of Ethel M. DuVal, deceased, for review of a decision of the Tax Court of the United States sustaining the action of the Commissioner of Internal Revenue holding a deficiency existed in the federal estate tax paid by petitioners on the said estate.

On August 17, 1937, the M. K. Blake Estate Company secured a loan from the Bank of America National Trust & Savings Association of Oakland, California, in the sum of $162,000, evidenced by the company's promissory note of the same date and secured by a deed of trust executed the same day. At the same time, and at the bank's request, the decedent, Ethel M. DuVal, and her sister, Mary J. Robinson, endorsed the note.

On November 2, 1941, the said M. K. Blake Estate Company borrowed an additional $20,000, giving its promissory note there-

for which was also secured by a deed of trust endorsed by the decedent and her sister. The sisters, by their endorsements, became primarily liable to pay the debt. Mrs. DuVal died April 9, 1942.

At the time of the decedent's death the unpaid balance of the principal of the two notes was $175,000. After the decedent's death the bank presented its claim for $175,000 against her estate. Said claim was allowed by the executors and probate court for the full amount. The executors of decedent's will claimed a deduction of the $175,000 in the federal estate tax return as a debt against ~~the decedent.~~

The questions presented are:

May the amount of decedent's asserted liability be deducted from the value of the gross estate under Section 812(b)(3) of the Internal Revenue Code, and, if so, should the value of decedent's rights over against the corporate maker and co-guarantor be included in the gross estate under Section 811 of the Internal Revenue Code?

If rights over existed in favor of deceased at the time of her death the questions must be answered in the affirmative.[1]

Petitioners contend there were no rights of contribution, subrogation or reimbursement in existence when decedent died which could be included in her estate or valued as of the date of decedent's death; that no such ~~rights exist in California until~~ the guarantor actually pays the guaranteed debt. This argument was advanced and rejected in the case of *Parrott v. Commissioner*.[2] We think the rights over existing in California in favor of the person secondarily or primarily liable become effective in California upon payment of the obligation as they do in other states.[3]

It is of no importance whether they are new rights independent of the original contract or old rights emerging from inchoate rights lying dormant. The revenue acts are intended to have a uniform application and to bring into the gross estate what is fundamentally the same in all estates, not colored by local characterization.[4] Whether the rights over be called a right of subrogation or a right of contribution, or a right to a right ~~of subro-gation or contribution,~~ ~~decedent at her death~~ had property ~~rights~~ of value, and ~~the right upon payment to acquire~~ the right of subrogation is the ~~property right which must be~~ included in the gross estate.

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[1] Parrott v. Com'r, 9 Cir., 30 F.2d 792, certiorari denied 279 U.S. 870; Com'r v. Wragg, 1 Cir., 141 F.2d 638.

[2] See Note 1.

[3] Arant on Suretyship, §§ 73, 75, 79.

[4] Lyeth v. Hoey, 305 U.S. 188.

No difficulty is encountered in fixing the value of the rights over. It is conceded that the company and the co-guarantor were, at the time of decedent's death, solvent and able to pay the claims and so continued up to the time of the hearing in the tax court. The Tax Court so found and its finding is not challenged. In fact, it may be said the question admits of no dispute, the petitioners having so stipulated. At the hearing before the tax court the petitioners endeavored to show by expert testimony the value of the rights over at the time of decedent's death. This testimony was rejected by the tax court and we think correctly so. When, as here the concession is made that the company was fully able to pay and discharge the debt, there is no reason to encumber the record by the introduction of opinion evidence as to the value. Such evidence would have been of no assistance to the tax court.

Petitioners complain that the tax court erred in concluding that the approval of petitioners' contention would "lead to absurd ends." We think such an absurdity clearly appears. In the instant case, had the sister of the decedent died before the payment of the claim and petitioners' position be correct, then a claim for a deduction of $175,000 from the sister's estate could have been urged. We might assume a case of several members of a family becoming co-guarantors on a note and all die prior to the payment of the claim. In such an event could the estate of each claim a deduction of $175,000? Surely such a contention could not be reasonably urged.

The decision of the tax court is affirmed.

Note

In *United States v. Frauenthal,* 138 F.2d 188 (C.C.A.8th, 1943), the decedent was contingently liable on certain claims. His executors deducted this liability on the estate tax return, but the deduction was disallowed by the Commissioner. Some time later the executors had to pay the contingent liabilities, but it was then too late to file a claim for refund, and their suit to recover the tax was dismissed. The court said: "Congress should, no doubt, have provided that the period for filing a claim for the refund of estate taxes overpaid because of the subsequent payment by an estate of contingent liabilities such as those here involved did not commence to run until the amount for which the estate was obligated upon such liabilities was determined and paid. The Government should not be allowed to retain moneys which do not belong to it, and which, in equity and good conscience, ought to be refunded."

REVENUE RULING 54-446

Internal Revenue Service, 1954. 1954-2 Cum.Bull. 303.

Decedent and his wife were parties to an antenuptial agreement whereunder she renounced and relinquished any marital rights she might acquire in his property or estate by reason of their marriage, and he, in turn, agreed to leave her certain property by will at his death. In his will decedent bequeathed his wife property different from but of a much greater value than that to which she was entitled under the antenuptial agreement, specifically providing that such bequests were in lieu of any rights she might have in and to property of his estate under such agreement. Section 812(b) of the Internal Revenue Code of 1939 [now found in sec. 2043(b) of the 1954 Code] provides that a relinquishment or promised relinquishment of dower or of a statutory estate created in lieu of dower or other marital rights is not to any extent a consideration in money or money's worth. Accordingly, any claim asserted against the estate by reason of such antenuptial agreement will not be allowable as a deduction under section 812(b) of the Internal Revenue Code. However, the full value of the interest given in satisfaction or in lieu of the wife's rights under the antenuptial agreement is considered as having "passed from the decedent to his surviving spouse," and if such interest otherwise satisfies all statutory requirements, the estate tax marital deduction authorized by section 812(e) of the Code [sec. 2056 of the 1954 Code] will be allowed.

Notes and Problem

(A) See also *Empire Trust Co. v. Commissioner,* 94 F.2d 307 (C.C.A.2d, 1938).

In *Markwell's Estate v. Commissioner,* 112 F.2d 253 (C.C.A. 7th, 1940), the decedent and his wife had entered into a separation agreement in 1909, by which the wife released all her marital and dower rights, and the decedent agreed to leave half of all his property at death to their daughter. The decedent died without complying with this provision. The daughter brought suit for specific performance against his estate, and received one-half of the property by order of the probate court. May this amount be deducted from the decedent's gross estate?

(B) Where a claim is barred by the statute of limitations, it may not be deducted even though paid by the executor, at least unless the claim has been allowed by the local probate court. *Wolf v. Commissioner,* 264 F.2d 82 (C.A.3d, 1959).

(C) When the decedent died, he left a liability for support payments under a separation agreement. These were to continue for the wife's life or until her remarriage. The wife did remarry before the estate tax return was filed. It was held that the deduction for the liability was limited to the actual payments made. *Commissioner v. Shively's Estate,* 276 F.2d 372 (C.A.2d, 1960).

Ithaca Trust Co. v. United States, 279 U.S. 151 (1929), stated at page 939(A), below, was distinguished. In *Commissioner v. Maresi*, 156 F.2d 929 (C.C.A.2d, 1946), where the wife remained unmarried, the court held that the value of the outstanding liability could be determined by recourse to actuarial tables.

(D) In *Taft v. Commissioner*, 304 U.S. 351 (1938), the Court held that an amount paid by the executors on a charitable subscription made by the decedent was not deductible, even though the estate was liable for it, since it was not a charitable bequest, and was not incurred for an "adequate and full consideration in money or money's worth." This result was changed by an amendment added in 1942 and now found in sec. 2053(c)(1)(A), which, in effect, makes enforcible charitable subscriptions deductible as if they had been charitable bequests.

(E) Until 1942, the amount of a valid claim against the decedent's estate was deductible in full, even though the estate was insolvent and unable to pay it. Thus the amount of such a claim might be deducted against insurance proceeds or other property which did not come into the hands of the executor, and even though the claim was not in fact paid. See *Commissioner v. Windrow*, 89 F.2d 69 (C.C.A.5th, 1937); *cf. United States Trust Co. v. Sears*, 29 F.Supp. 643 (D.Conn.1939). This result was changed by an amendment made in 1942, which disallowed as a deduction amounts which "exceed the value, at the time of the decedent's death, of property subject to claims."

This was further changed when sec. 2053 of the 1954 Code was enacted. The purpose of these changes may be seen from the following extract from the Committee Reports (House Report No. 1337, 83d Congress, 2d Session, p. A317; Senate Report No. 1635, 83d Congress, 2d Session, p. 474):

"Existing law provides that the total allowance in respect of such items cannot exceed the value of property included in the decedent's gross estate subject to claims. This section removes that limitation in the case of such items where the amounts thereof are paid (whether or not the total of all such items is in excess of property subject to claims) prior to the time prescribed for the filing of the estate tax return. For example, if the decedent's estate includes only property held by the decedent and his surviving spouse as tenants by the entirety, such items as funeral expenses, debts and other valid claims if allowable under local law and paid by the spouse prior to the time for filing the estate tax return, will be allowed by this section.

"In addition, subsection (b) allows as a deduction from the gross estate amounts representing expenses incurred in administering property not subject to claims included in the gross estate. All of the rules applicable to the expenses enumerated in subsection (a) of this section are equally applicable to the expenses described in subsection (b) except that a deduction for expenses incurred in administering property not subject to claims will be allowed if paid prior to the expiration of the period of limitations for assessment provided in section 6501. Such expenses include such items as principal commissions paid in respect of trust property included in the gross estate, and attorneys' fees incurred to contest the inclusion of the trust property in the decedent's gross estate."

Under sec. 2053, is jointly owned property, included in the gross estate, "property subject to claims"? See *Estate of Samuel Hirsch*, 14 T.C. 509 (1950). In *Estate of Herbert Jermain Slocum*, 21 T.C. 465 (1954), it was held that property subject to a power of appointment exercised by the decedent's will was not "property subject to claims" under South Carolina law.

(F) Section 2053 was amended by the Acts of February 20, 1956, and of August 21, 1959, so as to allow the deduction of the state tax imposed on a charitable bequest.

There was at one time a rather difficult problem with respect to the deduction of attorney's fees. Suppose for example a claim for refund is filed, based on an overvaluation of assets included in the gross estate. This goes to litigation, which turns out successfully. Attorney's fees are then paid. Can these be deducted? What about the statute of limitations, or the rules of res judicata, which may prevent the reopening of the estate's tax liability after the previous judgment? See *Moir v. United States,* 149 F.2d 455 (C.C.A.1st, 1945); *Bohnen v. Harrison,* 232 F.2d 406 (C.A.7th, 1946).

This question is now covered in broad terms by sec. 20.2053-3(c) of the Estate Tax Regulations, which provides that attorney's fees may be deducted even though "not claimed in the estate tax return or in the claim for refund." It is also provided that a deduction will not be denied "solely by reason of the fact that the amount of the fees to be paid was not established at the time that the right to the deduction was claimed."

Care should be taken, however, to see that a general claim for attorney's fees is included in any court case, and that this is taken into account in computing the final judgment. Otherwise the rules of res judicata may preclude any further recovery.

Reference should be made to the option which is given to the executor to deduct administration expenses against the estate's income for income tax purposes rather than to take them as an estate tax deduction. See sec. 642(g) of the 1954 Code. When this is done, income tax is saved, but estate tax is increased; and this may affect the amount of the residue, and may have rather surprising effects on the impact of the tax. In *Estate of Bixby,* 140 Cal.App.2d 326, 295 P.2d 68 (1956), it was held that if the income tax deduction is elected, the executor should make proper adjustments in his accounts so that the burden of the tax will not be borne by the residue of the estate. See also *In re*

Warms' Estate, 140 N.Y.S.2d 169 (1955); *Matter of Levy,* 9 Misc.2d 561, 167 N.Y.S.2d 16 (1957).[1]

Note

Administration expenses attributable to the earning of tax exempt income are not deductible on the income tax return because of sec. 265 of the 1954 Code. The Treasury has ruled that such expenses may be taken as a deduction on the estate tax return, even if other administration expenses are deducted on the income tax return. Rev.Rul. 59–32, 1959–1 Cum.Bull. 245. See also *Estate of Edward H. Luehrmann,* 33 T.C. 277 (1959), at page 936(B), below.

3. Losses

Sec. 2054 of the 1954 Code

Under sec. 2054 of the Code, the estate may deduct in computing the estate tax, the amount of losses sustained by the estate (after the death of the decedent) "from fires, storms, shipwrecks, or other casualties, or from theft." On the meaning of "other casualties," see *Lyman v. Commissioner,* 83 F.2d 811 (C. C.A.1st, 1936), which denied the deduction of a loss sustained by the estate when Great Britain went off the gold standard.

Note that the same deduction is also allowed in computing the estate's income tax by sec. 165 of the 1954 Code. Under sec. 165 (c)(3) no such loss can be allowed as an income tax deduction "if, at the time of the filing of the return, such loss has been claimed for estate tax purposes in the estate tax return." However, if the estate tax return has not been filed when the income tax return is filed, there is no limitation on the deduction for income tax purposes; and there appears to be no provision disallowing this deduction for estate tax purposes if it has previously been taken on an income tax return. There appears to be a lack of correlation between these two provisions. The objective is clear: the deduction can be taken either as an income tax deduction or as an estate tax deduction, but not for both purposes. But it is far from clear that the statutory provisions as written reach this result.

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[1] For discussion, see Bronston, "Elections and Discretions under the Code: The Executor's Dilemma," 35 Taxes 986 (1957); Boehm, "Comparing the Relative Tax Costs of Alternative Treatment of Estate and Income Deductions and Valuation Adjustments," 31 Rocky Mt.L.Rev. 172 (1959).

4. Charitable Bequests and Transfers

Sec. 2055 of the 1954 Code

The federal estate tax as originally enacted in 1916 did not allow the deduction of charitable bequests. The provision which is now sec. 2055 of the 1954 Code (previously sec. 812(d) of the 1939 Code) first appeared as section 403(a)(3) of the Revenue Act of 1918. It seems to have come into that statute almost by accident. It was not in the Bill as it was passed by the House. In the Senate the estate tax provisions of the House Bill were stricken out and an inheritance tax was substituted. See Senate Report No. 617, 65th Congress, 3d Session, p. 15. The Senate Bill contained a clause, doubtless modelled on the provisions of many state inheritance tax laws, to the effect that charitable gifts "shall not be taxable hereunder." There was no specific discussion of this provision in the Committee Report. When the Bill went to conference, the estate tax provisions of the House were reinstated, but the exemption of gifts to charities in the Senate's inheritance tax was carried over to the enacted law. The Conference Report contains no discussion of the problem, but merely a recital of the fact. See House Report No. 1037, 65th Congress, 3d Session, pp. 70–71 (Amendment No. 289).

The merits of the charitable deduction present a very complex social problem. Perhaps the extremes of the two opposing points of view appear in the following extract from an address on "Tax Exemptions" by Farwell Knapp, Tax Commissioner of Connecticut, in the Proceedings of the National Tax Association for 1934 (pp. 74, 77–78):

"I recall that at the time of my last brush with the charities, they indignantly asserted, in a written brief as well as in oral argument, that their own functions were the highest public uses; that accordingly any change in the existing situation of complete and undiscriminating exemption was outrageous because it would mean taking money from their self-styled highest public uses and employing it for the low and pernicious activities of the state. Of course they did not phrase it in exactly that way, but they did give away their hand by using the phrases 'highest public uses' and 'lower public uses' in the way I have indicated; and they quoted the statement of former President Eliot of Harvard that:

> 'It is at once apparent that this objection is both illogical and mean; illogical, because if churches, colleges and hospitals subserve the highest public ends, there is no reason for making them contribute to the inferior public charges. . . .'

With the greatest respect to President Eliot and others, this argument is simply preposterous.

"The so-called 'inferior public uses' of the state are in fact the basic and most important ones. It is a curious sort of prejudiced thinking which leads college presidents and other benevolent gentlemen to ignore the fact that the state provides the framework of security of person and property without which neither they nor anyone else could lead a civilized life or engage in any kind of organized activities. The state itself is the greatest charitable institution there is. It has no other function than serving the great human needs."

The argument of President Eliot, from which Mr. Knapp quoted, appears in full in a volume called Exemption from Taxation in Massachusetts 21–45 (1910). The issue is stated perhaps more happily in another part of this argument (p. 25) in the following terms: "If the State wants the work done, it has but two alternatives—it can do it itself, or it can encourage and help benevolent and public-spirited individuals to do it. There is no third way." See also Killough, "Exemptions to Educational, Philanthropic, and Religious Organizations" in Tax Exemptions (Tax Policy League, 1939) 23–38; Shoup, "Tax Exemption" in 14 Encyclopaedia of the Social Sciences 528 (1934).

The question is of course not peculiar to the estate tax. It is, however, sometimes presented in rather acute form in the case of very large estates. Should property devoted to public use be controlled by the persons whom we call the Government, or by persons of the decedent's own choice over whom his wishes and directions may exert a large measure of continuing control? It is not meant to assert that the present law is not desirable, but merely to raise the question. Obviously, too, the merits of the deduction in general should not be tested solely in terms of the occasional huge estate. Would a maximum limit on the amount of charitable gifts allowed as deductions be desirable? *Cf.* section 170(b) of the 1954 Code, relating to the income tax.

In 1942 the Treasury urged upon Congress that "The provision [allowing deduction of charitable bequests] also enables decedents to perpetuate through charitable trusts and corporations, family control over their wealth without paying the estate tax. The policy underlying the deduction of gifts to charity does not justify such results, and it is suggested that the deduction be limited to a specified percentage of the decedent's estate." See Statement of Randolph Paul, Tax Advisor to the Secretary of the Treasury, in Hearings Before the Committee on Ways and Means on "Revenue Revision of 1942," p. 92. No action was taken by either the House or Senate committees on this recommendation.

See, generally, Latcham, "Private Charitable Foundations: Some Tax and Policy Considerations," 98 U. of Pa.L.Rev. 617 (1950); "The Modern Philanthropic Foundation: A Critique and

a Proposal," 59 Yale L.J. 477 (1950); "The Use of Charitable Foundations for Avoidance of Taxes," 34 Va.L.Rev. 182 (1948); Harriss, "Federal Estate Taxes and Philanthropic Bequests," 57 J.Pol.Econ. 337 (1949).

HARRISON v. NORTHERN TRUST CO.

Supreme Court of the United States, 1943. 317 U.S. 476.

MR. JUSTICE MURPHY delivered the opinion of the Court.

Respondents, the executors under the will of Henry M. Wolf, brought this action to recover an alleged overpayment of federal estate taxes. The case turns upon whether under the provisions of § 303(a) of the Revenue Act of 1926, as amended by § 807 of the Revenue Act of 1932,[1] the amount to be deducted from decedent's gross estate on account of the bequest of his residuary estate to charity is the actual amount of such bequest, after payment of federal estate taxes, or what would have been the amount if there had been no such taxes.

Testator, a resident of Illinois, bequeathed the residue of his estate to four named charitable organizations. The will contained no provision as to the payment of federal or state death taxes except for a direction that all inheritance, legacy, succession and estate taxes upon certain specific bequests to individuals should be paid out of the general estate. The residuary estate, after deducting funeral and administration expenses and specific bequests but not the federal estate tax, amounted to $463,103.08, all of which sum respondents claim they are entitled to deduct from the statutory gross estate in computing the federal estate tax. The Commissioner of Internal Revenue ruled, however, that only that portion of the residue which was actually distributable to the charitable donees, *i. e.*, the amount remaining after payment of the federal estate tax, was deductible as a charitable bequest. He determined that the total estate tax amounted to $459,879.57, which would be paid out of the residuary estate, and that respondents were therefore entitled to deduct only $3,223.51, the amount actually passing under the residuary bequests.

[1] Section 807 provides as follows:

Sections 303(a)(3) and 303(b)(3) of the Revenue Act of 1926 are amended by inserting after the first sentence of each a new sentence to read as follows:

"If the tax imposed by section 301, or any estate, succession, legacy, or inheritance taxes, are, either by the terms of the will, by the law of the jurisdiction under which the estate is administered, or by the law of the jurisdiction imposing the particular tax, payable in whole or in part out of the bequests, legacies, or devises otherwise deductible under this paragraph, then the amount deductible under this paragraph shall be the amount of such bequests, legacies, or devises reduced by the amount of such taxes."

It is now part of § 812(d) of the Internal Revenue Code.

Respondents paid the assessed tax under protest and filed a claim for refund which the Commissioner rejected. This suit followed, and the district court entered judgment for respondents. The Circuit Court of Appeals affirmed. 125 F.2d 893. We granted certiorari because of the importance of the question in the administration of the federal estate tax system.

Section 807 recognizes that the ultimate thrust of the federal estate tax is to be determined by state law, cf. *Riggs v. Del Drago*, 317 U.S. 95, and provides that where the tax is, either under the will or the applicable local law, "*payable . . . out of* the bequests, legacies, or devises otherwise deductible under this paragraph, then the amount deductible under this paragraph shall be the amount of such bequests, legacies, or devises reduced by the amount of such taxes." [2] The court below fixed upon the words "payable out of" and held § 807 inapplicable because the federal estate tax was a charge against the entire estate and not against the residue under Illinois law,[3] and therefore was not "payable out of" the residuary bequest. The court then followed *Edwards v. Slocum*, 264 U.S. 61, where under substantially identical facts and in the absence of a statute such as § 807, the instant issue was resolved against the Government. In so doing the court below refused to examine the legislative history of § 807 on the ground that the section was unambiguous.

But words are inexact tools at best and for that reason there is wisely no rule of law forbidding resort to explanatory legislative history no matter how "clear the words may appear on 'superficial examination'." *U. S. v. Amer. Trucking Ass'ns,* 310 U.S. 534, 543–44. See also *United States v. Dickerson,* 310 U.S. 554, 562. So, accepting the Circuit Court's interpretation of Illinois law as to the incidence of the tax, we think it should have considered the legislative history of § 807 to determine in just what sense Congress used the words "payable out of". The committee reports on § 807 demonstrate that it was intended as "a legislative reversal of the decision" in *Edwards v. Slocum, supra* (H.Rep. No. 708, 72d Cong., 1st Sess., p. 50),[4] and that Congress used the words "payable out of" in the sense of "diminished or reduced by" the payment of the tax. Thus the House Report states:

> "The purpose of this amendment is to limit the deduction for charitable bequests, etc., to the amount which the decedent has in fact and in law devised or bequeathed to charity.

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[2] Emphasis added.

[3] The cases of People v. Pasfield, 284 Ill. 450; People v. Northern Trust Co., 289 Ill. 475; and People v. McCormick, 327 Ill. 547, were cited for this proposition.

[4] See also S.Rep.No.398, 68th Cong., 1st Sess., p. 35, and H.Conference Rep. No. 844, 68th Cong., 1st Sess., pp. 25–26, with reference to § 303(a) of the Revenue Act of 1924 which contained the same sentence as § 807.

Under existing law no consideration can be given to any estate, succession, legacy, or inheritance taxes imposed with respect to a decedent's estate even though by the terms of his will or the local law they actually reduce the amount of such bequest or devise." p. 49.

And, in referring to the situation in *Edwards v. Slocum,* it was said:

> "Under the State law the estate tax was payable generally out of the estate and so fell upon and reduced the residuary estate given to charity." p. 50.

That is the case here for while the estate tax may be a charge against the entire estate under Illinois law, admittedly its payment will operate to reduce the amount of the residuary estate. This legislative history is conclusive in favor of the Government's contention that respondents are entitled to deduct only the amount of the residuary estate actually passing to the charitable beneficiaries after provision is made for the payment of the federal estate tax.

It is argued on behalf of respondents that this interpretation of § 807 results in a "tax upon a tax" and is therefore unconstitutional. We need not stop to consider the accuracy of this nomenclature because this case involves only a charitable deduction which Congress could have denied altogether, and the limitations placed upon that deduction by § 807 clearly do not go beyond the limits of permissible constitutional power. Respondents also object to the fact that the tax may have to be computed by an algebraic formula or by complicated arithmetical methods because of the two mutually dependent variables, the amount of the tax and the amount of the residue as reduced by the tax, and reference is made to the statements in *Edwards v. Slocum* that "algebraic formulæ are not lightly to be imputed to legislators," 264 U.S. at 63. This contention loses all significance when it is remembered that § 807 was intended as a "legislative reversal" of *Edwards v. Slocum.* And compare *United States v. New York,* 315 U.S. 510.

The judgment is reversed and the cause remanded for further proceedings in conformity with this opinion.

Reversed.

Note

(A) Consider the problem of computing the amount of the deduction, where the tax comes out of the charitable gift, but the amount of the tax is affected by the amount of the gift. It is made more difficult by graduated rates and by the fact that state death taxes must be taken into consideration. See the "Greeley Formula," in Greeley, "Estate Tax, Deduction for Charity," 65 J. of Accountancy 433, 511 (1938), 66 *id.* 53, and formulas appearing in both the Prentice-Hall and Commerce Clearing House

Tax Services; Eastman, "Tax Computation in an Estate with a Charitable Remainder," 69 J. of Accountancy 175 (1940); Rockefeller, "Charts for Computing Estate Tax with Deductible Charitable Remainders," 27 Taxes 211 (1949), also in 86 J. of Accountancy 458 (1948). See also Burstein and Stein, "Computation of Estate Tax when Interdependent Deductions are Present," 29 Taxes 455 (1951).

(B) A died leaving the residue of his estate on trust to T to pay the income to X for life, with the remainder to a charity. The executor, acting under sec. 642(g) of the 1954 Code, deducted administration expenses against income on the estate's income tax return. It was held that nevertheless these expenses must be deducted from the residue in computing the amount of the estate tax deduction for a charitable bequest. *Estate of Edward H. Luehrmann,* 32 T.C. 277 (1959).

HENSLEE v. UNION PLANTERS NATIONAL BANK & TRUST CO.

Supreme Court of the United States, 1949. 335 U.S. 595.

PER CURIAM. Respondents are the executors and trustees of the estate of William Bate Williams. They brought this action for refund, with interest, of $35,899.12 of federal estate taxes and interest paid under protest. The relevant facts, set forth in respondents' complaint and admitted by the Collector's motion to dismiss, are as follows:

William Bate Williams died in 1943. Under the terms of his will, the entire gross estate of $508,411.17 was bequeathed to respondents to hold in trust for the testator's

"beloved mother, Elizabeth Bate Williams, for and during her natural life, with the full power and authority herein conferred.

"I hereby direct both my executors and my trustees to pay to my mother the sum of Seven Hundred Fifty ($750.00) Dollars a month to be used by her as she sees fit. In the event the income from my estate is not sufficient to pay the said Seven Hundred Fifty ($750.00) Dollars each month, then my executors and trustees are hereby empowered, authorized and directed to encroach on the corpus of the estate to pay said amount and to sell any of my property, real or personal, for this purpose.

"In addition to this amount my said executors and trustees are authorized and empowered to use and expend in their discretion any portion of my estate, either income or principal, for the pleasure, comfort and welfare of my mother.

"The first object to be accomplished in the administration and management of my estate and this trust is to take care of and provide for my mother in such manner as she may desire and my executors and trustees are fully authorized and likewise directed to manage my estate primarily for this purpose."

The will went on to provide for distribution of the corpus of the estate remaining at the mother's death. Twenty-five per cent of the total remaining estate was bequeathed to the testator's cousin, and stated sums in cash were left to other named legatees. After these legacies, the balance of the estate was directed to be paid over to four named charities, in equal shares.

At the time of the testator's death the estate was earning a net income of approximately $15,000 per year, $6,000 more than the amount directed to be paid, at $750 per month, to the testator's mother. The mother at that time was eighty-five years old, lived on substantially less than $750 per month, and had independent investments worth approximately $100,000 which netted her an income of about $300 per month. A woman of moderate needs and without dependents, she died three years later without having requested respondents to invade the trust corpus in her behalf.

The disputed estate tax liability resulted from respondents' attempt to deduct from the gross estate the portion bequeathed to the four charities, in reliance on the charitable deduction provision of § 812(d) of the Internal Revenue Code. The Commissioner denied the deduction. The Collector here resists the refund claim, on the ground that the possibility of invasion of the corpus on behalf of the testator's mother prevented the ultimate charitable interest, at the testator's death, from being "presently ascertainable, and hence severable from the interest in favor of the private use," within the meaning of the applicable Treasury Regulation.[1]

On the authority of *Merchants Nat. Bank of Boston v. Commissioner of Internal Revenue*, 320 U.S. 256, the District Court granted the Collector's motion to dismiss. 74 F.Supp. 113. The Court of Appeals reversed. 6 Cir., 166 F.2d 993. It held that notwithstanding the language of the testamentary provision for the "pleasure, comfort and welfare" of the mother, the complaint's allegations of the mother's great age, independent means and modest tastes raised a triable issue of fact as to whether the trust corpus was threatened with invasion and the charitable interest hence subject to depletion in favor of the testator's mother.

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[1] "If a trust is created for both a charitable and a private purpose, deduction may be taken of the value of the beneficial interest in favor of the former only insofar as such interest is presently ascertainable, and hence severable from the interest in favor of the private use. * * *" U.S. Treas.Reg. 105, § 81.44 (1942). Cf. id., at § 81.46: "If the legatee, devisee, donee, or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of such power."

We agree with the District Court that this case is governed by the decision in the *Merchants Nat. Bank of Boston* case and that the suit should be dismissed. It is apparent on the face of the complaint that this testator's will did not limit the trustees' disbursements to conformity with some ready standard—as where, for example, trustees are to provide the prime beneficiary with such sums as "may be necessary to suitably maintain her in as much comfort as she now enjoys." *Ithaca Trust Co. v. United States,* 279 U.S. 151, 154. The stated income here directed to be paid to the mother was "to be used by her as she sees fit." Beyond this the trustees were empowered to invade or wholly utilize the corpus of the estate for the mother's "pleasure, comfort and welfare," bearing in mind the testator's injunction that "The first object to be accomplished . . . is to take care of and provide for my mother in such manner as she may desire . . . ."[2] As in the *Merchants Nat. Bank of Boston* case, where the trustees had discretion to disburse sums for the "comfort, support, maintenance, and/or happiness" of the prime beneficiary, so here we think it the "salient fact . . . that the purposes for which the widow could, and might wish to have the funds spent do not lend themselves to reliable prediction." 320 U.S. 256, 258, 262.

We do not overlook the unlikelihood that a woman of the mother's age and circumstances would abandon her customary frugality and squander her son's wealth. But, though there may have been little chance of that extravagance which would waste a part or consume the whole of the charitable interest, that chance remained. What common experience might regard as remote in the generality of cases may nonetheless be beyond the realm of precise prediction in the single instance. The contingency which would have diminished or destroyed the charitable interest here considered might well have been insured against, but such an arithmetical generalization of experience would not have made this charitable interest "presently ascertainable." "Rough guesses, approximations, or even the relatively accurate valuations on which the market place might be willing to act are not sufficient." *Merchants Nat. Bank of Boston v. Commissioner of Internal Revenue, supra,* 261.

Nor do we think it significant that the trust corpus was intact at the mother's death, for the test of present ascertainability of

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[2] In view of the express priority accorded the mother's wishes, respondents' fiduciary duty to the ultimate beneficiaries, private and charitable, was ineffective to guarantee preservation of any predictable fraction of the corpus for disposition after the mother's death. The testator, indeed, made the gifts to charity subordinate not only to his mother's interest but to that of all the private beneficiaries, stating in his will that the charitable interest "is a residuary bequest . . . and is not to infringe on any of the other legacies hereinbefore provided."

the ultimate charitable interest is applied "at the death of the testator." *Ibid.* The charitable deduction is a matter of congressional grace, and it is for Congress to determine the advisability of permitting amendment of estate tax returns at such time as the probable vesting of the charitable interest has reduced itself to unalterable fact.

Reversed.

MR. JUSTICE DOUGLAS and MR. JUSTICE JACKSON dissent upon the grounds stated in dissent in *Merchants Nat. Bank of Boston v. Commissioner of Internal Revenue,* 320 U.S. 256, 257, at 263.

MR. JUSTICE FRANKFURTER, dissenting.

Wisdom too often never comes, and so one ought not to reject it merely because it comes late. Since I now realize that I should have joined the dissenters in the *Merchants Nat. Bank of Boston* case, 320 U.S. 256, I shall not compound error by pushing that decision still farther. I would affirm the judgment, substantially for the reasons given below. 6 Cir., 166 F.2d 993.

Notes

(A) In *Ithaca Trust Co. v. United States,* 279 U.S. 151 (1929), the gift was to the testator's widow for life with power to use from the principal any sum "that may be necessary to suitably maintain her in such comfort as she now enjoys." The remainder was given to charity. The widow died shortly after the decedent before his estate tax return was filed. The Court held that "the accident of the widow having died" should not be regarded, and would not affect the tax. But it also held that the computed value of the remainder, based on the wife's expectancy, could be deducted since "The income of the estate at the death of the testator, and even after debts and specific legacies had been paid, was more than sufficient to maintain the widow as required. There was no uncertainty appreciably greater than the general uncertainty that attends human affairs."

(B) In Rev.Rul. 54–285, 1954–2 Cum.Bull. 302, the Treasury stated its conclusions in this area as follows:

"In view of the foregoing it is held that a charitable deduction under section 812(d) of the Internal Revenue Code may be allowed on account of bequests or gifts of remainder interests to charity in cases where the will or instrument authorizes invasion of corpus for the comfortable maintenance and support of life beneficiaries if (1) there is an ascertainable standard covering comfort and support which may be either express or implied, and (2) the probability of invasion is remote or the extent of the invasion is calculable in accordance with some ascertainable standard."

(C) Note the last sentence in sec. 2055(a) with respect to the effect of a "complete termination . . . of a power to consume, invade or appropriate property for the benefit of an individual before such power has been exercised," as a disclaimer of the power under the parenthetical clause at the beginning of sec. 2055(a).

Section 2055(b) was amended by the Act of August 6, 1956. This is apparently one of the amendments designed to take care of a particular case. Under this, if the donee of the power is 80, he is given a year within which to name charitable beneficiaries. If he does so exercise the power, the first estate gets the deduction.

(D) In *Humes v. United States*, 276 U.S. 487 (1928), cited in the principal case, the will left property to the testatrix's niece for life, with the principal to be paid to her at certain designated ages. If she should die without issue before attaining the age of forty the property was to be given to charity. The Court held that the statute should not be construed as allowing a deduction where "Neither taxpayer, nor revenue officer—even if equipped with all the aid which the actuarial art can supply—could do more than guess at the value of this contingency." [1]

(E) This result was adhered to in *Commissioner v. Estate of Sternberger*, 348 U.S. 187 (1955), where a bequest was left to the decedent's wife and daughter, and during the life of the survivor. On the death of the survivor, the principal was to be paid to the then living descendants of the daughter. If there were no such descendants, then the property went to charity. The daughter was 27 years old when the decedent died. She had been married and divorced, and had never had a child. Actuarial evidence was introduced to show the chance that the daughter would leave a descendant surviving her. This evidence was based on data much more recent than that relied on in the *Humes* case.

The Supreme Court held that no charitable deduction was allowable. It said: "This Court finds no statutory authority for the deduction from a gross estate of any percentage of a conditional bequest to charity where there is no assurance that charity will receive the bequest or some determinable part of it." The distinction appears to be between situations where the charity is sure to take, but the time of taking is uncertain, on the one hand, and situations where the condition is such that the charity may not take at all, on the other. The case is noted in 55 Col.L.Rev. 924 (1955).

(F) In *United States v. Provident Trust Co.*, 291 U.S. 272 (1934), the will left property to the decedent's daughter for life, with remainder to her issue, with a provision that if she should die without issue the remainder should go to charity. At the time of the decedent's death the daughter was fifty years old, and she had previously undergone an operation which made it impossible for her to bear children. The Court held that evidence to this effect was admissible, and that the value of the remainder was deductible.[2]

United States v. Dean, 224 F.2d 26 (C.A.1st, 1955), involved a transfer by will to a trustee with a provision that the remainder

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1 Cf. Seacrest, "Fertility Tables—A Method to Resolve the Tax Valuation of Property Transfer Containing Birth Contingencies," 29 Nebraska L.Rev. 17 (1949).

2 Cf. Hoagland v. Kavanagh, 36 F.Supp. 875 (E.D.Mich.1941), where the gift was to A for life, with remainder to charity if A died without issue. A was 45 years old, unmarried, childless, and had pulmonary tuberculosis, of which he died two months after the testator's death. No deduction was allowed.

should go to charity if A, an old lady, survived two other persons. There was no question of "issue," or of the wishes or volition of the life tenant. The court held that the chance here was not so remote as to be insignificant, and disallowed any charitable deduction. See also *Moffett v. Commissioner*, 269 F.2d 738 (C.A. 4th, 1959).

See, generally, Spang, "The Uncharitable Disallowance of Charitable Remainders," 29 Taxes 61 (1951); Hartung, "Estate Tax Deductions for Gifts to Charity—The Certainty Requirement," 13 Geo.Wash.L.Rev. 198 (1945); "Deductions from Estate Tax for Conditional Gifts to Charity," 28 Va.L.Rev. 387 (1942). See also Drye, "Testamentary Gifts of Income to Charity," 13 Tax L.Rev. 49 (1957); Quiggle and Myers, "Tax Aspects of Charitable Contributions and Bequests by Individuals," 28 Fordham L.Rev. 579 (1960).

(G) The decedent left a will in which he said: "I have heretofore expressed to my sons my wishes as to certain charitable gifts, and I therefore make no such bequests herein, preferring that my sons shall make such donations within their sole discretion as shall seem to them to be best." The sons gave $1,000,000 to St. Louis University. Is this deductible in the computation of the father's gross estate? See *Mississippi Valley Trust Co. v. Commissioner*, 72 F.2d 197 (C.C.A.8th, 1934), cert. den., 293 U.S. 604 (1934). See also *Delaney v. Gardner*, 204 F.2d 855 (C.A.1st, 1953).

(H) A bequest of an intestate share is left to a son who is in a religious order. Under the rules of the order, anything that he receives goes to the order. This does not provide a basis for a charitable deduction. Rev.Rul. 55–759 and Rev.Rul. 55–760, 1955–2 Cum.Bull. 607; *Estate of Margaret E. Callaghan*, 33 T.C. 870 (1960).

(I) The Georgia Code provides that a will containing a charitable devise must be executed at least ninety days before the testator's death, "or such devise shall be void." The decedent died 89 days after making a will leaving charitable gifts. Eight days later the decedent's widow and only surviving child renounced all rights they might have under the statute. Is the charitable gift deductible? Is this a "disclaimer" within the meaning of the parenthetical clause in sec. 2055(a)? See *Commissioner v. First Nat. Bank*, 102 F.2d 129 (C.C.A.5th, 1939). *Cf. Dumont's Estate v. Commissioner*, 150 F.2d 691 (C.C.A.3d, 1945).

5. Marital Deduction

Sec. 2056 of the 1954 Code

The Revenue Act of 1948 added an entirely new concept to the estate tax. This is the marital deduction now found in sec. 2056 of the 1954 Code. When this was enacted, the provisions which had been added to the 1939 Code in 1942 with respect to community property (section 811(d)(5) of the 1939 Code, relating to inter vivos transfers of community property, section 811(e)(2), relating to community property held by the decedent and

his spouse at the time of death, and section 811(g)(4), relating to life insurance purchased with community property) were repealed.

The provisions of sec. 2056, allowing the marital deduction, are complex, and must be studied carefully. At this point, as is so often the case, the focus of study and attention must be on the STATUTE. In general, this section allows an additional deduction from the gross estate in the amount of any property other than community property, left to the surviving spouse of the decedent, up to half the value of the gross estate after allowing for debts, claims, and losses. The latter concept (that is, the value of the gross estate after the deductions of secs. 2053 and 2054, and excluding community property) is designated as the "adjusted gross estate." See sec. 2056(c). The marital deduction is not allowed for any property unless it is left to the surviving spouse outright, or in such a way as to be taxable in his or her estate if it still remains at the time of the survivor's death.

The details of this provision become relatively clear when its general purpose and objective are kept in mind. It was enacted at the time that the "split income" provisions were added to the income tax. The purpose sought to be achieved by the split income provision was to put the community property states and the rest of the country on a substantially equivalent basis as far as the income tax is concerned. The marital deduction is intended to produce the same consequence in the estate tax field. In a community property state, only half of the community property is included in the decedent's estate when he dies. The other half belongs outright to the survivor. The decedent in a common law state may now achieve substantially the same result by leaving half of his property to his surviving spouse. But he must leave it outright, or taxable to the survivor, or else he could arrange to escape the tax in the survivor's estate, too, which result cannot be achieved in a community property state, where the survivor's half is out of the control of the decedent, and must go to the survivor outright.

Thus the marital deduction, and its limitations, are both intended to produce a large measure of equality between the common law states and the community property states. This is a major development in the estate tax field, and goes far towards making the estate tax a sound and fair method of taxation.

It might be thought that the marital deduction would produce a heavy loss of revenue, since any married person can eliminate half of his estate from any tax, and this half comes out of the top brackets. However, the loss is not as great as would appear. With the marital deduction, half of the property is taxable in the estate of the spouse who dies first, and the other half is taxable

in the estate of the surviving spouse, together with that spouse's other property. However, before the marital deduction, estates of any size were almost always left on trust for one person (often, or usually, the surviving spouse) for life, with remainder to others, such as the children. Thus there was a tax on the entire property when the first spouse died, but no tax at all (on the property in the trust) when the second spouse died.

Query: Should there be a 100% marital deduction instead of one limited to 50% of the adjusted gross estate?

Note

The marital deduction provisions are analyzed and discussed in Sugarman, "Estate and Gift Tax Equalization—The Marital Deduction," 36 Calif.L.Rev. 223 (1948); Surrey, "Federal Taxation of the Family—The Revenue Act of 1948," 61 Harv.L.Rev. 1097 (1948); Casner, "Estate Planning Under the Revenue Act of 1948", 62 Harv.L.Rev. 413 (1949); Casner, "Estate Planning under the Revenue Act of 1948—The Regulations," 63 Harv.L. Rev. 99 (1949); Casner, "Estate Planning—Marital Deduction Provisions of Trusts," 64 Harv.L.Rev. 582 (1951); Smith, "Marital Deduction in Estate Planning," 32 Taxes 15 (1954); Fleming, "Present Status of the Marital Deduction," 33 Taxes 167 (1955).

STARRETT v. COMMISSIONER

United States Court of Appeals, First Circuit, 1955. 223 F.2d 163.

MAGRUDER, CHIEF JUDGE. Frank E. Tingley, a resident of Rhode Island, died October 3, 1948. In the estate tax return filed by his executor, a so-called "marital deduction" under § 812 (e) (1) (F) of the Internal Revenue Code, was claimed in the full amount of the value of certain property which passed to the surviving spouse pursuant to paragraph 3, § 1, of Tingley's will, quoted hereinafter. The Commissioner of Internal Revenue ruled that such marital deduction was not allowable, and determined a deficiency accordingly. In the Tax Court of the United States this ruling of the Commissioner was upheld. The executor then duly petitioned this court for review of the Tax Court decision.

. . .

Under § 1 of paragraph 3 of the will of Frank E. Tingley, a trust was created of a stated portion or share of the residual estate in favor of the surviving spouse, Mary Elizabeth Tingley. The trustee was directed to pay over to her, as nearly as possible in equal quarterly installments, all the net income from such trust estate for and during the term of her natural life, for her own use. Further, the will provided that the trustee

> "shall, at any time or from time to time, upon the request in writing of my said wife, transfer, convey and pay over to

her any part or parts or the whole of said first share free from trust for her absolute use, provided that such right of my wife to call for the transfer or conveyance to her of any part or parts or the whole of the principal of said first share shall cease in case of her legal incapacity from any cause or upon the appointment of a guardian, conservator, or other custodian of her person or estate; and in the event of such legal incapacity, or appointment of any guardian, conservator or other custodian of her person or estate, my said wife or her guardian, conservator or other custodian shall cease to have any further right to the payment to her or such representative of any specified sum or of any part of the income from said first share * * *."

Mrs. Tingley, the surviving spouse, exercising her power under the foregoing provision of the will to call upon the trustee for the payment over to her of the principal, on November 17, 1948, which was shortly after the death of the testator, created a trust of her entire share under the will. In fact, Mrs. Tingley never became legally incapacitated, and no guardian, conservator or other custodian of her person or estate was ever appointed. She died on August 5, 1952.

Both here and before the Tax Court the parties were in agreement that the widow's power to invade the corpus of the aforesaid testamentary trust was equivalent to a power of appointment within the meaning of § 812(e)(1)(F). Further, both parties were in agreement that the only issue to be determined was whether, viewed as of the date of Mr. Tingley's death, the widow's power to invade the corpus was exercisable by her "alone and in all events." The reference is to the language in the concluding sentence of subparagraph (F) of § 812(e)(1) to the effect that the marital deduction allowed therein is applicable "only if, under the terms of the trust, such power in the surviving spouse to appoint the corpus, whether exercisable by will or during life, is exercisable by such spouse alone and in all events." [1]

Petitioner argues that the surviving spouse might properly be considered to have become the virtual owner of the property in question, and that her subsequent exercise of the power to invade the corpus by the creation of a trust disposing of the property at her death made the property a part of her estate for estate tax purposes. This all may be conceded, but the argument does not successfully avoid the effect of the restrictive "in all events" requirement in subparagraph (F). Notwithstanding the statement in the Senate committee report, above quoted, that subparagraph (F) was designed "to allow the marital deduction for such cases where the value of the property over which the sur-

[1] This language is now found in sec. 2056(b)(5) of the 1954 Code Ed.

viving spouse has a power of appointment will * * * be subject to either the estate tax or the gift tax in the case of such surviving spouse", it is perfectly clear from the face of the statute, as well as from the legislative history, that there is no requirement that the marital deduction provisions must be so construed that only one tax may be collected upon the property in question, either from the decedent or the surviving spouse. Thus, it is unquestionable that a general power of appointment exercisable only so long as the donee remains unmarried is not a power exercisable "in all events" within the meaning of § 812 (e)(1) (F). See Treas.Reg. 105, § 81.47a(c), 1949–1 Cum.Bull. 200. The marital deduction is not available to the decedent's estate in such a case; yet the surviving spouse is subject to a gift tax if she exercises or releases the power *inter vivos,* or the property is treated as part of the surviving spouse's gross estate upon her testamentary exercise, or failure to exercise, the power in question, 26 U.S.C. §§ 811(f), 1000(c).

Of course it is true that the power in the surviving spouse must be viewed as of the date of the decedent's death, in determining whether the power is exercisable "in all events" within the meaning of subparagraph (F). Thus if by the terms of the decedent's will a gift in trust to the surviving spouse is coupled with a general power of appointment which, though otherwise absolute, is terminable in the event that X should survive the testator, and if in fact X dies before the testator, then the decedent's estate would qualify for the marital deduction under subparagraph (F) since, viewed as of the date of the testator's death, it would be apparent that the terminating contingency could never occur. But if X should die after the testator and before the collection of the estate tax, the marital deduction would not be available since, viewed again as of the date of the testator's death, the power in the surviving spouse would not be exercisable "in all events."

We agree with the Tax Court that the marital deduction was properly disallowed in this case, because the power in the surviving spouse to invade the corpus was not exercisable by her "in all events", in view of the terminating condition, as specified in the will, "in case of her legal incapacity from any cause or upon the appointment of a guardian, conservator, or other custodian of her person or estate". [22 T.C. 403.] Not only that, but upon the happening of the same terminating condition she would lose the absolute right to demand payment of the trust income, and hence, under the terms of the trust, the surviving spouse was not "entitled for life to all the income from the corpus of the trust". § 812(e)(1)(F).

It is petitioner's contention that the testamentary limitations on the surviving spouse's power do not add substantially to

those which would otherwise prevail under Rhode Island law, and therefore should be disregarded on the implication that Congress, in requiring that the power must be exercisable "in all events", could not have meant to deny the marital deduction where the terminating condition is one which would be supplied anyway as a matter of local law. Following out this line of thought, petitioner argues that though there is no Rhode Island decision squarely in point, the Rhode Island Supreme Court would probably follow *Equitable Trust Co. v. Union National Bank,* 1941, 25 Del.Ch. 281, 18 A.2d 228, in applying the asserted general rule that a power of appointment cannot be exercised by a guardian, because such power is not part of the incompetent's estate which the guardian is appointed to manage. On the other hand, the Commissioner asserts that under Rhode Island law, in the event that the widow should become legally incapacitated, the power to invade the corpus could be exercised in her behalf by her guardian or conservator, absent the terminating restrictions in the decedent's will, citing in this connection *Jacques v. Swallow,* 1951, 77 R.I. 517, 78 A.2d 4; *In re Houghton's Estate,* 1954, 118 Vt. 229, 105 A.2d 257, 263.

We think the Commissioner probably has the better of the argument on this question as to the local law of Rhode Island. But we do not pause to make a definite determination upon the point, since the Commissioner has an alternative argument to which petitioner makes no real attempt to respond and which we regard as irrefutable. This alternative contention is: Assuming for the moment that under Rhode Island law a guardian or conservator would not be permitted to exercise a power of appointment held by the incompetent, the appointment of a guardian or conservator would result, without the limiting condition in the will, in no more than a suspension of the power during the period of disability, however long or short it might be; whereas under the terms of the will the power of appointment ceases, finally and absolutely, upon the occurrence of the legal incapacity or the appointment of a guardian or conservator. Hence the terms of the will impose a significant condition in addition to that which would be supplied by the applicable state law, a condition which, viewed as of the date of the decedent's death, made it possible that the surviving spouse's power of appointment would not be exercisable "in all events."

The decision of the Tax Court is affirmed.

Notes

(A) As the principal case shows, the marital deduction provision must be strictly complied with, and it is somewhat tricky. Great care must be taken in drawing marital deduction provisions in wills and trusts. The following are some instances of

interests where question has been raised whether the interest was terminable and thus not qualified for the marital deduction:

Though the Treasury first ruled otherwise, the courts have held that an amount paid to a widow in a lump sum as the "fair equivalent" of dower, under an Alabama statute, does qualify for the marital deduction. *United States v. Crosby,* 257 F.2d 515 (C.A.5th, 1958); *United States v. Traders Nat. Bank,* 248 F.2d 667 (C.A.8th, 1957).

Where the decedent and his wife executed a joint and mutual will, declaring that they owned all of their property jointly, and agreeing that the survivor should have the use of the property for life, with the remainder to named relatives, it was held that the surviving wife took an estate in fee simply by survivorship, and a marital deduction was allowed. *Estate of Emmet Awtry v. Commissioner,* 221 F.2d 725 (C.A.8th, 1955).

Where the decedent left his estate to his wife for life, with remainder to two sons, and the wife was also given the power to use the property as she might need for the way of life to which she had been accustomed, no marital deduction was allowed. *Estate of Michael Melamid,* 22 T.C. 966 (1954).

Other problems arising with respect to the marital deduction may be illustrated by the following examples:

Where the decedent bequeaths to his spouse an amount equal to half his adjusted gross estate, and the executors elect to take administration expenses as an income tax deduction, rather than an estate tax deduction, only the amount actually allowed as a deduction under the estate tax can be used to reduce the adjusted gross estate. Consequently, the widow gets half of the adjusted gross estate computed without any deduction for administration expenses. Rev.Rul. 55–643, 1955–2 Cum.Bull. 386.

A remainder was left to a second wife. Children of a former wife contested the will, and an agreement was entered into that the second wife would bequeath what she received to the decedent's grandchildren, and not dispose of the assets except for her own maintenance and care. It was held that no marital deduction was allowable. *Estate of Thomas W. Tebb,* 27 T.C. 671 (1957), noted in 43 Va.L.Rev. 740 (1957).

See also Lauritzen, "Common Disaster Can Mean Tax Disaster," 1 Tax Counselor's Q. 1 (1957); "The Marital Deduction in Federal Estate Tax: The Terminable Interest Rule," 107 U. of Pa.L.Rev. 1176 (1959).

Insurance

(B) Insurance proceeds were payable to the decedent's surviving spouse only if she was living on receipt by the insurer of due proof of the insured's death; otherwise they were payable to named secondary beneficiaries. Since submission of due proof of the insured's death might be made more than six months after his death, the wife might lose her interest if she died after the expiration of the six months period. It was held that a marital deduction was allowable. The wife's interest was held to be "vested" in her on the decedent's death. *Eggleston v. Dudley,* 257 F.2d 398 (C.A.3d, 1958).

But where proceeds of insurance were payable in installments, and on the death of the surviving spouse before all installments became due, the remaining proceeds would go to others named by the decedent, no marital deduction was allowed. *Estate of Thomas J. White,* 22 T.C. 641 (1954); *Werbe's Estate v. Commissioner,* 273 F.2d 201 (C.A.7th, 1959); *Meyer v. United States,* 275 F.2d 83 (C.A.2d, 1959). Contra: *Reilly v. Commissioner,* 239 F.2d 797 (C.A.3d, 1957).

See, generally, Lawthers, "Basic Planning Principles in Qualifying Life Insurance for the Marital Deduction," 37 Taxes 723 (1959).

(C) Note the provision of sec. 2056(b)(4)(A) of the 1954 Code under which the amount of state legacy or inheritance taxes are to be taken into account in determining the amount of the marital deduction. What is the effect on this of the credit against the Federal estate tax of state death taxes, taken together wih a state apportionment statute, such as that involved in *Harvey Estate,* at p. 958, below? See *Estate of Edward V. Babcock v. Commissioner,* 234 F.2d 837 (C.A.3d, 1956).

(D) One unfortunate defect in the original statute allowing the marital deduction was corrected by sec. 2056 of the 1954 Code. In the statute as first enacted it was provided (sec. 812 (e)(1)(F) of the 1939 Code) that the marital deduction would apply with respect to property left in trust if the surviving spouse was entitled to all the income for life, and had power to appoint "the entire corpus" free of trust. It was held in several cases that no marital deduction was allowable where a trust was set up which gave the widow all the income, but where she had power to appoint only half or some other fraction of the corpus. Rev. Rul. 54–20, 1954–1 Cum.Bull. 195; *Estate of Louis B. Hoffenberg,* 22 T.C. 1185 (1954); *Estate of Shedd v. Commissioner,* 237 F.2d 345 (C.A.9th, 1956).

In sec. 2056(b)(5) of the 1954 Code it is now expressly provided that the marital deduction will apply to a "specific portion" of the trust property, if the surviving spouse has power to appoint that portion. Sec. 2056(b)(5) is also applicable to legal interests; the original statute had been applicable only to property put in trust, and not to legal life estates with unlimited powers of invasion. See Schuyler, "Legal Life Estates and the Marital Deduction," 1 Tax Counsellor's Q. No. 2, p. 47 (1957); *Pipe v. Commissioner*, 241 F.2d 210 (C.A.2d, 1957), noted in 57 Col. L.Rev. 893 (1957), and in 71 Harv.L.Rev. 381 (1957). But cf. *Estate of McGehee v. Commissioner,* 260 F.2d 818 (C.A.5th, 1958—on rehearing), to the contrary.

E. CREDITS

Secs. 2011–2016 of the 1954 Code

1. Credit for State Death Taxes

Sec. 2011 of the 1954 Code

Sec. 2011 of the 1954 Code provides a credit for "any estate, inheritance, legacy, or succession taxes actually paid to any State or Territory or the District of Columbia, or any possession of the United States." The amount of this credit is specified in sec. 2011(b). The somewhat odd figures in this subsection are the result of the fact that the credit in its present form began in 1926, and the amount of the credit is 80% of the estate tax imposed by the Revenue Act of 1926.

This credit device was first introduced in the 1924 Act; at that time the limit was fixed at 25% of the tax. In 1926, the Senate repealed the estate tax entirely, but it was restored in conference, and the credit was fixed at 80% of the 1926 tax where it has remained. See House Report No. 356, 69th Congress, 1st Session, pp. 49–50 (Amendment No. 100). The constitutionality of the credit was sustained in the case of *Florida v. Mellon,* 273 U.S. 12 (1927).[1]

The object of the credit, of course, is to induce the states to have a death tax. As a result, every state except Nevada has an inheritance or estate tax. Some have both, first an inheritance tax, and then an estate tax which is fixed in amount at the difference between the inheritance tax and the limit on the federal estate tax credit. See Mass.Acts 1932, c. 284; Texas Stats. (Vernon 1944) Art. 7144a, involved in the following case. In this way the full credit is absorbed by the state.[2]

ESTATE OF ALLEN L. WEISSBERGER

Tax Court of the United States, 1957. 29 T.C. 217.

FORRESTER, Judge:[3] Petitioner paid to the State of Ohio the amount of $6,710.41 on account of the inheritance tax imposed by that State. Of that amount, $3,677.22 was paid under permanent

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[1] See Machen, "The Strange Case of Florida v. Mellon," 13 Cornell L.Q. 351 (1928).

[2] See Cogburn, "The Credit Allowable against the Basic Estate Tax for Death Taxes Paid to the States and State Statutes Enacted to Take Advantage Thereof," 30 N.C.L.Rev. 123 (1952); Perkins, "State Action under the Federal Estate Tax Credit Clause," 13 No.Car.L.Rev. 271 (1935); Morrissett, "The Effects of the Federal Estate Tax Credit on State Finances," Proc. Nat.Tax.Assn. 729 (1938).

[3] The findings of fact, and the opinion on another issue, are omitted.

order, pursuant to one provision of State law, and the remaining $3,033.19 was paid under temporary order, pursuant to another provision thereof.

Under Ohio law, the tax rate may vary depending upon the nature of actual succession to the decedent's estate. Where such succession is subject to conditions or contingencies a tax is imposed at the highest rate possible under any resolution thereof. If succession as ultimately determined warrants a lower tax, a refund may be made of the excess. Ohio Rev.Code Ann. sec. 5731.28 (Page 1954).

The payment under temporary order was of the foregoing nature. It was not, however, a mere deposit, which is provided for elsewhere by State statute. Ohio Rev.Code Ann. sec. 5731.30 (Page 1954).

Respondent has determined that no part of the amount paid under temporary order qualifies for the credit against the basic estate tax as set forth in section 813(b) of the Internal Revenue Code of 1939.[3] We believe that determination erroneous.

Respondent's argument, based upon the possibility of a refund in the future, is unsound. A refund of any tax paid is always possible, at least until barred by an applicable period of limitation. A tax paid may have to be refunded in whole or in part for any one of an infinite variety of reasons. To deny the credit claimed here simply because a future refund is possible is to judicially repeal section 813(b).

Furthermore, Congress has recognized the possibility of such refunds and has made express provision therefor. Sec. 874(b)

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3 Sec. 813. Credits Against Tax.

(b) Estate, Succession, Legacy, and Inheritance Taxes.—The tax imposed by section 810 or 860 shall be credited with the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or Territory or the District of Columbia, or any possession of the United States, in respect of any property included in the gross estate (not including any such taxes paid with respect to the estate of a person other than the decedent). The credit allowed by this subsection shall not exceed 80 per centum of the tax imposed by section 810 or 860 (before deducting from such tax the credits provided by section 813(a)(1) and (2)), and shall include only such taxes as were actually paid and credit therefor claimed within four years after the filing of the return required by section 821 or 864, except that—

(1) If a petition for redetermination of a deficiency has been filed with The Tax Court of the United States within the time prescribed in section 871, then within such four-year period or before the expiration of 60 days after the decision of The Tax Court becomes final.

(2) If, under section 822(a)(2) or section 871(h), an extension of time has been granted for payment of the tax shown on the return, or of a deficiency, then within such four-year period or before the date of the expiration of the period of the extension.

Refund based on the credit may (despite the provisions of sections 910 to 912, inclusive), be made if claim therefor is filed within the period above provided. Any such refund shall be made without interest.

(3), I.R.C. 1939.[4] The normal period of limitation will not bar respondent from collecting any additional estate tax due as a result of the refund of a part of the amount paid under temporary order.

We have in the past denied a contention virtually identical to that which respondent makes here. *Estate of Pamphila H. Phillips*, 36 B.T.A. 1102. We see no material distinction between that case and this with respect to the credit under section 813(b), and can find no reason to depart from the rule there expressed.

In *Edward C. Moore, Jr., et al., Executors,* 21 B.T.A. 279, cited by respondent, we denied a credit for a mere deposit, and further denied the credit for a tax paid where it was not shown to have been paid in respect of property included in the decedent's gross estate. As we read the stipulation of facts in the instant proceeding, the amount in question was in fact paid and not merely deposited, and was paid in respect of property included in the gross estate. Thus the *Moore* case is not in point. We conclude that respondent erred in respect of this issue.

Decision will be entered under Rule 50.

Notes and Problems

(A) See "State Death Taxes: Utilization and Apportionment of Federal Estate Tax Credit," 98 U. of Pa.L.Rev. 102 (1949). *Cf. Treichler v. Wisconsin,* 338 U.S. 251 (1949), where it was held that a state could not use its tax (designed to use up the 80% credit) as a means of taxing property outside the state.

(B) Suppose that the state law imposes the tax with respect to appointed property on the estate of the donor of the power rather than the donee. May this tax be credited against the federal tax due from the estate of the donee of the power? See *Fletcher v. Commissioner,* 29 B.T.A. 503 (1933), reversed on the other grounds, 74 F.2d 1014 (C.C.A.5th, 1935).

(C) The credit device has been extended to other fields. See sec. 3301 of the 1954 Code which is designed to provide for unemployment insurance. By sec. 3302 the taxpayer may obtain a credit up to ninety per cent of the tax on account of payments made to state unemployment funds. This was sustained in *Steward Machine Co. v. Davis,* 301 U.S. 548, 585 (1937).

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[4] SEC. 874. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

(b) Exceptions.—

* * * * * * * * * * * *

(3) Recovery of Taxes Claimed as Credit.—If any tax claimed as a credit under section 813(b) or (c) or section 936(c) is recovered from any foreign country, any State, any Territory or possession of the United States, or the District of Columbia, the executor, or any other person or persons recovering such amount, shall give notice of such recovery to the Secretary at such time and in such manner as may be required by regulations prescribed by him, and the Secretary shall redetermine the amount of the tax under this chapter and the amount, if any, of the tax due upon such redetermination, shall be paid by the executor or such person or persons, as the case may be, upon notice and demand.

The Bituminous Coal Conservation Act of 1935, c. 824, 49 Stat. 991, contained a provision imposing a tax on producers of coal, and allowing a credit of ninety per cent of this tax to producers who accepted certain price and labor standards. This was held invalid in *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936). Thereafter sec. 3520(b)(2) was added to the 1939 Code, containing an exemption (amounting in effect to a one hundred per cent credit) in favor of any producer of bituminous coal "who is a code member." Being a code member meant in substance that the price and labor provisions and other requirements of the Bituminous Coal Act of 1937, c. 127, 50 Stat. 72, had been accepted. This was sustained in *Sunshine Anthracite Coal Co. v. Adkins,* 310 U.S. 381 (1940).

2. Gift Tax Credit

Sec. 2012 of the 1954 Code

Sec. 2012 of the 1954 Code allows a credit against the estate tax where the gross estate of the decedent includes any property on which he has paid a gift tax. The credit may not exceed the proportion of the total estate tax which the property given bears to the entire gross estate. This provision is obviously applicable in the case of a gift in contemplation of death. Whether it has any other operation must be considered in the light of the decision in *Estate of Sanford v. Commissioner,* 308 U.S. 39 (1939), *infra,* p. 970, and related cases.

As originally enacted, the gift tax credit was taken before the 80% credit for state death taxes. This had the effect of reducing the latter credit, and might make the overall taxes payable greater where a gift had been made than where there was no gift. This situation was changed by an amendment made in 1942, so that the statute now provides that the credit for gift tax shall be taken after the credit for state death taxes. See sec. 2012(a).

Note and Problem

(A) In *Horner's Estate v. Commissioner,* 130 F.2d 649 (C.C.A. 3d, 1942), it appeared that the decedent and his wife owned property as tenants by the entirety which they conveyed to a trustee to pay the income to themselves for life, with remainder to another person. The decedent and his wife each paid gift tax on this transfer. On the husband's death, the entire value of the property was included in his gross estate. It was held that the entire amount of gift tax paid, including that paid by the wife, was available for credit against the estate tax. This result is criticised in a comment in 56 Harv.L.Rev. 649 (1943).

(B) Where gifts were made in 1950 and 1951, but no gift tax was paid for 1950 because of the specific exemption, no credit against the estate tax was allowed for the 1950 gifts, and the computation of the limitation on the credit with respect to the 1951 gifts was made by considering the 1951 gifts alone. *Estate of Frank B. Chapman,* 32 T.C. 599 (1959).

(C) Because of the credit for gift taxes, the aggregate tax payable will ordinarily be less if the decedent has made gifts in contemplation of death than it will be if he retains the property until his death. There is thus a tax differential in favor of making gifts in contemplation of death as against retaining the property until death. Why is this? See, Generally, Tomlinson, "The Gift Tax Credit against the Estate Tax," 109 J. of Accountancy 52 (May, 1960).

3. Credit for Prior Taxed Property

Sec. 2013 of the 1954 Code

The estate tax is a sort of capital levy, and the rough and ready theory is that it should be imposed once a generation. But an unfortunate series of events may result in the imposition of the tax two times, or even more often, within a relatively short space of time. The estate tax law has long contained provisions designed to relieve against hardship where the estate of a decedent contains property which has already been subjected to estate tax within a relatively recent time.

Until the enactment of the 1954 Code, this was done by allowing the *deduction* of such prior taxed property from the gross estate, subject to certain limitations. The period prescribed was five years. If the prior decedent had died within five years, the prior taxed property was deductible in full; if the period was more than five years no deduction was allowed. Under this arrangement, the saving of tax in the estate of the second decedent bore little if any relationship to the amount of tax paid in the first decedent's estate. Thus, if the first decedent had a small estate, the tax paid with respect to property he left might have been relatively small. If some of this property was in the estate of a person who died thereafter within five years, the prior-taxed property would be deductible in the second decedent's estate; and if the second decedent had a large estate, the estate tax saved by the deduction might be correspondingly large, and many times the tax paid in the first decedent's estate.[1]

In sec. 2013, the relief from hardship in the case successive death within a short space of time is provided by a *credit*. Under this, the tax saved in the second estate can never exceed that paid with respect to the property by the first estate. In the 1954 Code, the period is extended from five to ten years, but the amount of the credit is subject to percentage diminution, in five steps, over the ten year period. See sec. 2013(a) of the 1954 Code.

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[1] For detailed discussions of the prior law, which had much to do with the changes made in 1954, see Bittker and Frankel, "Previously Taxed Property and the Federal Estate Tax," 8 Tax L.Rev. 263 (1953); Rudick, "The Estate Tax Deduction for Property Previously Taxed," 53 Col.L.Rev. 761 (1953).

Several changes and improvements were made in this provision when it was put into sec. 2013 of the 1954 Code.

When the marital deduction was introduced in 1948, it was provided that no deduction for prior taxed property should be allowed with respect to property acquired by a decedent from his spouse. This is changed by sec. 2013(d)(3), under which any property acquired by the surviving spouse in excess of the marital deduction may be taken into account in computing the credit for prior taxed property.

Under the prior law the deduction was allowed to the second estate only when specific property (or its proceeds) could be traced as having come from the first decedent's estate, and was included in the gross estate of the second decedent. This presented a number of problems which have been eliminated from the present statute. See *Rodenbough v. United States,* 25 F.2d 13 (C.C.A.3d, 1928); *Farmers' Loan & Trust Co. v. United States,* 60 F.2d 618 (S.D.N.Y., 1932); *Bahr v. Commissioner,* 119 F.2d 371 (C.C.A.5th, 1941).

The previous statute applied only when property had been acquired by "bequest, devise or inheritance" from the prior decedent. It was uncertain whether this included property to which the later decedent had succeeded as surviving joint tenant, or tenant by the entirety, after the death of the prior decedent. See *Commissioner v. Fletcher Savings & Trust Co.,* 59 F.2d 508 (C.C.A.7th, 1932). But *cf. Lang v. Commissioner,* 289 U.S. 109 (1933).

Under the prior law the deduction was allowed only with respect to the first preceding death within five years. If there were three deaths within five years, the deduction could be taken in the estate of the second decedent, but not in that of the third. In the new sec. 2013, the credit is available, subject to the percentage limitations prescribed, in the estates of both the second and the third decedents.[2]

Section 2013 of the 1954 Code is also applicable with respect to transfers from the estate of a person who died within two years *after* the death of the decedent whose estate is being subjected to tax. How can this provision come into operation?

Suppose that A transfers property to a trustee on trust to pay the income to A for life, with remainder to her son B. Thereafter B dies while A is still living. B leaves no will, and A is his

[2] See Rudick, "The Estate Tax Credit for Prior Transfers," 13 Tax L.Rev. 3 (1957); Tomlinson, "Estate Tax Credit for Prior Transfers," 104 J. of Accountancy 31 (Oct.1957); Chirelstein and Shieber, "Property Previously Taxed under the Revenue Act of 1954," 33 Taxes 773 (1955).

only heir. Eight months later A dies. What are the estate tax consequences? Will either estate be entitled to a credit for prior taxed property?

Prior to the enactment of the 1954 Code, the provision for a deduction for previously taxed property was also applicable to property left by the decedent on which a *gift tax* had been paid by a transferor within five years before the decedent's death. This has been changed by sec. 2013 of the 1954 Code. The new provision makes no allowance of a credit in case a previous gift tax has been paid within ten years. It is applicable only with respect to property which was included in the gross estate of the transferor.

4. Credit for Foreign Death Taxes

Sec. 2014 of the 1954 Code

In 1951, Congress for the first time enacted a provision allowing a credit for death taxes paid to any foreign country "in respect of any property situated within such foreign country and included in the gross estate." This provision now appears in sec. 2014 of the 1954 Code. It is somewhat analogous to the foreign tax credit provided for the income tax in secs. 901–905 of the 1954 Code.

In the case of alien decedents, this credit is on a reciprocal basis, and is not available unless the other country allows a similar credit to citizens of the United States.

There are two further provisions with respect to credits, in sec. 2015, relating to a credit for death tax on remainders, and in sec. 2016, dealing with the situation where a tax for which a credit is allowed is later recovered.

F. NONRESIDENT ALIEN DECEDENTS [1]

Secs. 2101–2106 of the 1954 Code

The estate tax is applicable to nonresident aliens, but the gross estate of a nonresident alien decedent includes only "that part of his gross estate . . . which at the time of his death is situated in the United States." Sec. 2103 of the 1954 Code. Under sec. 2104 this does not include stock in foreign corpora-

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[1] See generally, Wurzel, "Nonresident Aliens and the Federal Estate Tax: A Legislative Problem," 40 Col.L.Rev. 52 (1940); Schneider, "Aliens and the Estate and Gift Tax Laws," 28 Taxes 715 (1950); Schneider, "Aliens and the United States Estate and Gift Taxes," 35 Taxes 281 (1957); "Death Taxes and the Alien, Treaty Considerations," 1960 Wis.L.Rev. 74.

tions even though the certificates are kept in the United States. This is a change from the previous law.

The other provisions of secs. 2101–2106 should be examined. Note that the exemption in the cases of a nonresident alien's estate is only $2,000. Sec. 2106(a)(3). Note, too, the limitation in sec. 2106(b) on the allowance of the deduction for debts and expenses, and for charitable gifts and bequests.

Under sec. 2102, the credits for death taxes, gift taxes, and prior-taxed property are applicable in determining the tax of non-resident alien decedents. With respect to the credit for state death taxes, sec. 2102 incorporates the credit allowed by sec. 2011, which by its terms is applicable only to estates in excess of $40,000. Thus, if the taxable estate is $40,000 or less, a nonresident alien's estate gets no credit for state death taxes.

The credit for foreign death taxes (though available to a *resident* alien decedent, subject to the condition stated in sec. 2014(a)) is not allowed to the estates of nonresident alien decedents.

The taxability of United States bonds owned by non-resident aliens is now covered by sec. 2106(c) of the 1954 Code, which carries forward a provision first added in 1951. In the case of such a decedent, United States bonds issued before March 1, 1941, are not taxable. Obligations issued on or after March 1, 1941, are taxable if they were "situated in the United States" at the time of the decedent's death. See sec. 2103 of the 1954 Code.

See also sec. 2105(c) of the 1954 Code, also first added in 1951, which provides that works of art loaned by a non-resident alien shall not be subject to estate tax in the United States when they are here solely for exhibition purposes in a public gallery or are en route to or from such an exhibition.

G. COMPUTATION AND PAYMENT OF THE TAX [1]

Prior to the 1954 Code, the estate tax was in form a dual tax. There was the "estate tax," which was simply the tax imposed by the Revenue Act of 1926, at relatively low rates. Then there was also the "additional estate tax," at very substantial rates. Only the "estate tax" was subject to the credit for the state death taxes paid, up to 80% of the "estate tax."

In the 1954 Code, these two tax rate schedules have been combined into a single tax in sec. 2001. The amount of the credit

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[1] See Williams, "Preparing for the Federal Estate Tax Return," 26 Taxes 917 (1948); Harriss, "Federal Estate Tax Administration," 28 Taxes 341 (1950).

is fixed by sec. 2011(b) at figures which are in fact 80% of the "estate tax" rates of the prior law. The old terminology is perpetuated in sec. 2011(d). This was necessary because a number of states fix their death taxes at 80% of the "estate tax" imposed by the Federal government. It is also necessary for the application of sec. 2201 of the 1954 Code, under which the "additional estate tax" is not applicable to the estates of certain decedents who were on active service with the armed forces.

The Federal tax is an estate tax, and in the absence of some effective provision to the contrary is payable out of the residue of the estate. See sec. 2205 of the 1954 Code. Thus where specific gifts are made to named persons, with the residue to charity, the burden of the tax is borne by the charity despite the fact that the gift to charity is deductible, and thus free from tax. See *Y. M. C. A. v. Davis,* 264 U.S. 47 (1924), and *Harrison v. Northern Trust Co.,* set out on p. 849, above.

In order to spread the burden of the tax, several of the states now have statutes providing that in the absence of a direction in the will to the contrary the federal estate tax "shall be equitably prorated among the persons interested in the estate." [2] The validity of such state statutes was sustained in *Riggs v. del Drago,* 317 U.S. 95 (1942). See also the special provisions in sec. 2206 of the 1954 Code as to life insurance, and in sec. 2207 as to property subject to a power of appointment. Should there be a general federal provision for apportionment of the estate tax? [3] See "Proposal for Apportionment of the Federal Estate Tax," 30 Indiana L.J. 217 (1955); Lauritzen, "Apportionment of Federal Estate Taxes," 1 Tax Counsellor's Q. No. 2, p. 55 (1957); La Plante, "Proration of Estate Taxes in Connecticut," 33 Conn.B.J. 397 (1960); "Statutory Apportionment of Federal Estate Taxes," 62 Harv.L.Rev. 1022 (1949); Mitnick, "State Legislative Apportionment of the Federal Estate Tax," 10 Md.L.Rev. 289 (1949); Fleming, "Apportionment of Federal Estate Taxes," 43 Ill.L.Rev.

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[2] E. g., Ark.Acts 1943, Act 99; Md.Acts, c. 546, 1937; Mass. Laws, c. 519, 1943; N.J.Laws 1950, c. 327; N.Y.Decedent Estate Law, § 124; 20 Pa.Stat. § 844. Cf. R.I.Gen.Laws, c. 43, sec. 33 (1938). Similar statutes are also in effect in California, Connecticut, Delaware, Florida, Kansas, Kentucky, Maine, Minnesota, Nebraska, North Dakota, Ohio, Tennessee, Texas, Virginia, West Virginia, and Wyoming.

The Massachusetts statute was held valid in its application to a tax paid after its enactment although the decedent had died before the statute was passed. Merchants Nat. Bank v. Merchants Nat. Bank, 318 Mass. 563, 62 N.E. 2d 831 (1945). But see In re National City Bank, 93 N.Y.S.2d 790 (1948), where it was held that the Florida apportionment statute, passed after the decedent's death could not be applied with respect to a trust he had created in New York.

[3] There is such a provision in the Australian Act. The problems which it has presented are discussed in Whitfeld, "Apportionment of Federal Estate Duty," 8 Aust.L.J. 118, 167 (1934).

153 (1948); "Administrative Difficulties in the Proration of the Federal Estate Tax," 21 Conn.B.J. 168 (1947).[4]

For another aspect of the problem, see Sutter, "Apportionment of the Federal Estate Tax in the Absence of a Statute or an Expression of Intention," 51 Mich.L.Rev. 53 (1952).

HARVEY ESTATE

Supreme Court of Pennsylvania, 1944. 350 Pa. 53, 38 A.2d 262.

HUGHES, JUSTICE. R. Wistar Harvey died October 21, 1939, leaving an estate valued in excess of $2,000,000. His will, dated May 2, 1936, contained: (1) pecuniary legacies aggregating $235,000, each "subject to the payment of the Pennsylvania State Inheritance Tax"; (2) specific legacies in which it was provided the tax thereon was to be paid out of the residue; and (3) a residuary legacy in trust, the income to be divided by the trustees after deducting from gross income, taxes and legal expenses thereon. At the audit the executors requested that a percentage of the pecuniary legacies be retained to permit apportionment of the federal estate taxes.

The questions raised on this appeal are: (1) Does the Act of July 2, 1937, P.L. 2762, 20 P.S. sec. 844, operate to require apportionment of estate taxes between pecuniary and residuary legatees? The appellants contend that since the pecuniary legacies are expressly made "subject to the payment of the Pennsylvania State Inheritance Tax" they are impliedly relieved of all other tax. The Act of 1937, supra, provides that estate taxes in all cases shall be apportioned among the parties interested in the gross taxable estate according to the amounts of their interest *"except in a case where a testator otherwise directs in his will."* In sec. 11 of the Wills Act of June 7, 1917, P.L. 403, 20 P.S. sec. 223, there is a provision that a general devise of a testator's estate "shall be construed to include any real estate * * * which he may have power to appoint in any manner he may think proper, and shall operate as an execution of such power *unless a contrary intention shall appear by the will."* (Italics supplied.) We stated in *Provident Trust Co. of Philadelphia, Trustee, v. Scott et al.,* 335 Pa. 231, 234, 6 A.2d 814, 816: "What this statute does, in the absence of a specific and unmistakable intention of the testator to exercise the power, by express reference in his will, is to create a presumption of his intention to execute it. * * * This presumption may be overcome, moreover, only by the pres-

[4] See also Sheffield, "Notes on Equitable Apportionment of Federal Estate Taxes—A Consideration of the New York Statute," 19 Conn.B.J. 6 (1945); Karch, "Apportionment of Death Taxes," 54 Harv.L.Rev. 10 (1940); "Apportionment of Federal Estate Taxes: Which Fund Bears the Burden?" 40 Col.L.Rev. 690 (1940).

ence in the will of language clearly indicative of a contrary dispositive intent, or of a form or method of disposition inconsistent with an exercise of the power. The contrary intent must appear from the will itself, not from extraneous circumstances." Like the Act of 1917, supra, the Act of 1937, supra, expressly supplies a presumption of the testator's intention and, when read into this will, is the equivalent of an express provision that these pecuniary legacies are subject to federal inheritance taxes. Unless there is in the terms of the will some provision which is clearly inconsistent with such construction, and, when the will is construed as a whole, will override it, the will shall be construed in accordance with the presumption provided by the statute. The appellants contend we should search for the testamentary intent in construing how these taxes shall be paid. With this contention we have no disagreement, but the statute creates a presumption which can only be overcome by clear language. When the statute is applied in this case, requiring each pecuniary legacy to pay its pro rata share of the federal tax, there appears no expression in the will of any intent by the testator to impose the full burden of the federal tax on the residuary legatees in contravention of the statute.

The appellants contend that the statute should not apply to pecuniary legacies, for if it does it is unconstitutional. Under Article IX, Section 1, of the Constitution of Pennsylvania, requiring uniformity of taxation, the statute in question lacks no uniformity in its application to all the legacies. The variance is due to the graduated federal tax as applied under the rule laid down in the statute. All beneficiaries are affected alike by its application. It was pointed out in *Riggs v. del Drago,* 317 U.S. 95, that such a statute is not in conflict with the Federal Estate Tax Statute, it does not contravene the supremacy clause of the Constitution; nor does the fact that the ultimate incidence of the federal estate tax is governed by the state law violate the requirement of geographical uniformity. The Apportionment Act of 1937, supra, is an administrative provision governing the distribution of estates under the Fiduciaries Act. The right of the states to fix and determine the incidence of the federal estate tax among the legatees of the estate has been frequently recognized. See *Young Men's Christian Ass'n v. Davis,* 1924, 264 U.S. 47, and *Riggs v. del Drago,* supra.

The appellants further contend that in the apportionment of state taxes an aliquot share should be allocated to residuary gifts to charitable beneficiaries. Section 812 of the Internal Revenue Code, already in effect October 21, 1939, provides that the net estate shall be determined by deducting from the value of the gross estate (a) an exemption of $100,000; (b) expenses, losses, indebtedness and taxes; (c) property previously taxed; (d)

transfers for public, charitable and religious uses. The estate tax, unlike the normal state inheritance tax, is a tax upon the property of the decedent. *In re Mellon's Estate,* 347 Pa. 520, 532. It is left to the states to determine what interests in the estate should bear the burden of the taxes. The Apportionment Act of 1937, supra, was passed for that purpose. In construing the Act, the learned judge of the court below said: "In determining the purpose of this act we must refer also to the Internal Revenue Act which it was enacted to execute and to whose terms it refers and partly adopts. Given this setting, it is unquestionable that the purpose of the Pennsylvania Act is to equitably apportion the burden of the tax. Therefore, in our opinion the application of the equitable doctrine of contribution demands that the tax be borne commensurately by those whose gifts contribute to the tax burden and conversely that there be eliminated from such burden all whose legacies do not in any way create or add to the tax. This is best illustrated by supposing the case of an estate wherein everything is bequeathed to public, charitable or religious purposes. In such case, under the Revenue Act, to the extent that the charity actually receives the money it is exempt from Federal tax. On the other hand, in an estate where there are no such gifts, all of the legacies pay proportionately, because they all contribute to the burden of the tax. The act lacks an express direction to 'thrust' any of the tax upon the charities and, therefore, we cannot conceive that the Pennsylvania Legislature intended to violate the spirit of the Federal Act, whose provisions allowing the deductions of the charitable legacies are practically written into the Pennsylvania Act." This was a proper construction and interpretation of the statute.

The decree affirmed; costs to be paid by the appellants.

Notes

(A) Suppose a decedent, owning all of the stock of a corporation, leaves a portion of the stock to the corporation by his will. The balance of the stock he leaves to his relatives or others, as he may choose. If the state has an apportionment statute, does the corporation have to pay a portion of the estate tax? Is this a way to get money out of the corporation for estate tax purposes without paying a dividends tax? If not, why not?

(B) In *Matter of Scott,* 274 N.Y. 538, 10 N.E.2d 538 (1937), cert. den. 302 U.S. 721 (1937), noted in 37 Col.L.Rev. 866 (1937), and 50 Harv.L.Rev. 134 (1936), the decedent left an insurance policy payable to the beneficiary in installments. It was held that the executor could recover the proportional amount of the tax from the insurance company, with the beneficiary's installments being reduced accordingly.[1]

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[1] See "Executor's Right to Reimbursement from Insurer under New York Decedent Estate Law § 124," 54 Col.L.Rev. 299 (1954).

The recovery in the *Scott* case was by the executor under the New York apportionment statute. Suppose that the estate of the decedent has no assets, but he leaves insurance which is subject to the Federal estate tax but payable to the beneficiary in installments. Can the Federal Government collect the tax from the insurance company? See the material at pages 1069–1083, below.

(C) Apportionment statutes may present difficult questions of jurisdiction and conflict of laws. In *First Nat. Bank v. First Trust Co.*, 242 Minn. 226, 64 N.W.2d 524 (1954), the decedent died domiciled in Florida. He had previously executed a trust in Minnesota with a Minnesota bank as trustee. This trust was made in settlement of claims in connection with a divorce, and it was included in his gross estate. Florida had an apportionment statute, and Minnesota did not. The executor paid the tax and then sued in Minnesota to recover a proper proportion of what he had paid. Recovery was denied. It was held that the Florida apportionment statute could have no effect on the Minnesota trust. There is a comment on the case in 39 Minn.L.Rev. 314 (1955). See also *Isaacson v. Boston Safe Deposit and Trust Co.*, 325 Mass. 469, 91 N.E.2d 334 (1950). The problems are discussed in Scoles, "Apportionment of Federal Estate Taxes and Conflict of Laws," 55 Col.L.Rev. 261 (1955).

Problem

A man dies fifteen months before the present date, and his executors have ascertained the following facts:

(a) He owned stocks and bonds in his own name which were worth $400,000 on the date of his death; to 33

(b) his wife survived him, and her statutory marital interest in his estate is worth, $100,000 (this represents her statutory share in her husband's assets, not additional assets beyond those mentioned in other paragraphs); to 34

(c) in 1955 he made gifts to his sons in the aggregate amount of $50,000; Inc -0- to 35

(d) in 1930 he had transferred property then worth $90,000 to a trustee upon trust for himself for life, remainder to his wife for life, remainder to his children; the property in this trust was worth $120,000 when he died; two children survived him;

(e) in 1936 he transferred property to a trustee upon trust "to pay the income to my two children during my life, remainder to such of them as survive me, in equal shares"; this was the entire dispositive provision of the instrument; the property was worth $60,000 when he died;

(f) in 1914, at the time of his marriage, he created a revocable trust for his wife; the property was then worth $40,000; at the time of his death it was worth $80,000; the trust had never been revoked; by its terms the wife was entitled to all the income as long as she lived, and she had power to appoint the remainder as she might wish on her death;

(g) in 1915, he caused Blackacre to be transferred to himself and his wife as tenants by the entirety; he paid all the consideration, which was $25,000; Blackacre was worth $40,000 when he died;

(h) he left $100,000 in life insurance payable to his wife, and $100,000 payable to his children, on which he had paid all the premiums and retained the incidents of ownership.

(i) under his father's will he had a power to appoint $50,000 among his children, which he exercised by his will;

(j) he also exercised a power to appoint among his children contained in a trust which he had created in 1925 irrevocably for his wife for her life, remainder among his children as he might by will appoint; the trust property was worth $60,000 when he died; his wife was then 65 years old;

(k) he had debts, funeral and administration expenses amounting to $75,000;

(*l*) he made the following bequests: to charity $60,000; to his wife $100,000 outright (this was in lieu of her statutory interest in his estate, and she accepted it); residue to his children;

(m) the state inheritance taxes payable in connection with his estate have been settled and amounted to $37,000.

Compute the total federal estate taxes payable by the decedent's estate. If you need any more facts assume them.

Note

For consideration of special problems, see:

Lowndes, "Tax Planning for Estates under the New Estate and Gift Tax Regulations," 1959 Duke L.J. 182.

Struckler, "Estate Planning and the Sole Proprietor," 36 Minn. L.Rev. 674 (1952).

"Divorce and the Estate and Gift Taxes." 36 Minn.L.Rev. 918 (1952).

Powell, "Ultimate Liability for Federal Estate Taxes," 1958 Wash.U.L.Q. 327.

CHAPTER 12

GIFT TAX

Secs. 2501–2524 of the 1954 Code

Regulations were issued with respect to the Gift Tax under the 1954 Code on November 14, 1958. They may be found in 1958–2 Cum.Bull. 627, and in the tax services under the section numbers corresponding to the Sections of the Code.

The gift tax is now thoroughly covered in Mertens, Law of Federal Gift and Estate Taxation, 6 vols., 1959; Beveridge, Law of Federal Estate and Gift Taxation, 3 vols., 1959; Stepheno and Marr, The Federal Estate and Gift Taxes (1959); Lowndes and Kramer, Federal Estate and Gift Taxes (1956).

A tax on gifts was first introduced into the federal revenue system in sections 319–324 of the Revenue Act of 1924.[1] The purpose expressed in the discussions in Congress was as much to protect the income tax as the estate tax. The impediment to tax avoidance was hardly very great, as the tax was computed annually, with no provision for cumulation of gifts, and there was an annual exemption of $50,000. As the rate was only one per cent on the first $50,000 of taxable gifts, a donor could give away $100,000 a year at a cost of only $500 annually.

This tax was repealed by section 1200 of the Revenue Act of 1926, effective as of January 1, 1926. (By section 324 of the same Act the rates under the 1924 Act were retroactively reduced.) At the same time the two-year conclusive presumption provision was added to the gift in contemplation of death clause of the estate tax. See section 302(c) of the Revenue Act of 1926; *supra,* p. 838(E). This was held invalid in *Heiner v. Donnan,*

1 A gift tax amendment was adopted by the Senate in 1921. See sections 412–416 of the Revenue Bill of 1921 as passed by the Senate; 61 Cong.Rec. Part 7, pp. 7485–7487. But it was omitted in conference. See House Report No. 486, 67th Congress, 1st Session, p. 47 (Amendment No. 622). In 1924, a tax on gifts was offered as an amendment on the floor of the House and was adopted. 65 Cong.Rec. Part 3, pp. 3199–3122; Part 4, pp. 3170–3177. The Senate Committee omitted the provision, saying that: "Any annual tax on gifts, such as that proposed, may be readily evaded by spreading the gifts over a period of years. For this reason, as well as that such a tax would be extremely difficult to enforce, since gifts are ordinarily made between persons occupying confidential relationships, the tax would mean little by way of revenue to the Government." Senate Report No. 398, 68th Congress, 1st Session, p. 39. But the sections were restored on the floor of the Senate, with the rates increased. 65 Cong.Rec. Part 8, pp. 8094–8097. Some modifications were made in conference (House Report No. 844, 68th Congress, 1st Session, pp. 8–10, 27–28 (Amendment No. 179)), and the tax became a law with the President's approval on June 2, 1924.

285 U.S. 312, on March 21, 1932; but in anticipation of the decision the House Committee had already recommended that the tax on gifts be restored. House Report No. 708, 72d Congress, 1st Session, pp. 8, 27–31. This became a law with the Revenue Act of 1932, on June 6, 1932. Its distinctive feature is its cumulative operation, under which the tax on any gift is at a rate fixed by putting it in the bracket determined by aggregating all the gifts made by the donor since the tax became effective. The rates have been increased several times, and there have been a few other amendments to bring it to the form now found in sections 2501–2524 of the 1954 Code. The tax is extensively discussed in Harriss, Gift Taxation in the United States (1940).[2]

An adequate understanding of the structure of the tax can be had only by getting out the statute and studying through its terms.

Constitutionality. The constitutionality of the 1924 gift tax was sustained in *Bromley v. McCaughn,* 280 U.S. 124 (1929). The argument against the tax was that it was a direct tax which was not apportioned, and that it violated the Fifth Amendment and was not uniform, because of its graduated rates and exemptions. As to the first contention, the Court held that the tax falls "into that category of imposts or excises which, since they apply only to a limited exercise of property rights, have been deemed to be indirect and so valid although not apportioned."[3] The other contentions were found by the Court to be foreclosed by many cases which had established that "The uniformity of taxation throughout the United States enjoined by Article I, Section 8, is geographic, not intrinsic," and which had upheld graduated rates in inheritance or succession taxes.

Retroactivity. The gift tax in the Revenue Act of 1924 was in terms applicable "For the calendar year 1924," although the statute did not become a law until June 2, 1924. *Blodgett v. Holden,* 275 U.S. 142 (1927) (see also 276 U.S. 594 (1928)), involved a gift made in January, 1924. The Court held it not taxable, but divided four to four in reasoning. Four held that the statute applied, and that "the challenged enactment is arbitrary and for that reason invalid." The other four, relying on *Shwab v. Doyle,* 258 U.S. 529 (1922), and other cases, held that "The Act should be read as referring only to transactions taking place after it was passed." In *Untermyer v. Anderson,* 276 U.S. 440 (1928), the gift was made on May 23, 1924, after the Revenue Bill of 1924 including the gift tax had been passed by both houses

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2 See also Harriss, "Legislative History of Federal Gift Taxation," 18 Taxes 531 (1940).

3 The problem is discussed in "The Direct Tax Clause and the Federal Gift Tax," 26 Col.L.Rev. 852 (1926), 5 Selected Essays on Constitutional Law 679 (1938).

of Congress, and while the Conference Report was pending. This time five members of the Court joined in an opinion holding the statute unconstitutional as applied to this gift. Mr. Justice Sanford concurred in the result; and Justices Holmes, Brandeis and Stone dissented. Mr. Justice Brandeis wrote a vigorous dissenting opinion, which contains a careful review of many cases involving retroactivity in federal taxation, and calling attention to the English practice in this respect under which revenue measures are applied retroactively at least "to the date when the government's resolutions were agreed to by the House of Commons sitting as a Committee of Ways and Means."

The gift tax imposed by the Revenue Act of 1932 was expressly made applicable only to the portion of that year "after the date of the enactment of this Act." Section 531(a) of the Revenue Act of 1932. There are consequently no further questions of retroactivity as far as the present gift tax is concerned. See sec. 2502(b) of the 1954 Code. The general problem is discussed in Ballard, "Retroactive Federal Taxation," 48 Harv.L.Rev. 592 (1935). The problem still remains in certain cases, however, to determine when the gift was made. And this may involve the question of determining *what* is a gift.

For general discussion of problems of gift taxation, see Casner, "Estate Planning," 68 Harv.L.Rev. 222 (1954).

Transfers

RICHARDSON v. COMMISSIONER

United States Circuit Court of Appeals, Second Circuit, 1942. 126 F.2d 562.

[The taxpayers, brothers, owned shares of stock which they kept in their safe deposit boxes in another city. On May 18, 1932, they notified their clerk that they were making gifts of the stock to their wives, and the clerk made notations to that effect on the cards she kept. They reported to their wives what they had done, and the wives said that they accepted the gifts. On May 27, 1932, they told one of their business associates (Dawson, who was an officer of a family financial company, called Piedmont) what they had done, and asked to have the necessary papers prepared. He made out assignments in blank for the stock in question, which were signed by the donors and returned to him. The gift tax law was enacted on June 6, 1932. On June 9, 1932, the donors removed the stock from their safe deposit boxes, and mailed the certificates to Dawson. On June 20, 1932, the shares were transferred to the wives on the books of the company.]

FRANK, CIRCUIT JUDGE. . . . The Board held that the taxpayers did not, before the date of the enactment of the gift tax provisions, make completed gifts of the stock represented by certificates in their respective safe deposit boxes in Greensboro. From these adverse decisions, the taxpayers have appealed.

A completed gift involves two major ingredients: (a) an intention to make a gift, and (b) certain ritualistic or ceremonial conduct involving relinquishment by the donor of what is called "dominion" or "control." Neither ingredient alone will suffice. Each is a necessary, but neither, alone, is a sufficient condition. They are sometimes difficult to keep separate, for the same evidence may bear on both. The requirement of an intent to give is, of course, beyond criticism. The ceremonial requirement has, however, been criticized. It is, to be sure, a survival from an older period whose perspective was far different from ours.[1] But, if not carried to excess, that ritualism has still some value, serving to show that the donor knows he is engaging in an act which will be taken seriously;[2] it is thus something of a preventive of fraud.

Considering what Paul has called the "bed chamber" aspect of purported gifts between husband and wife, in the light of the artificiality of the tax law provisions—which, in spite of the obvious two-in-one character of the marriage status, allow each spouse to be a separate taxpayer—it would be arguable (and the Commissioner so intimates) that in the case at bar there was no intention to make gifts.[3] But we are spared the difficult job of dissecting the record with those none-too-sharp implements "intent," "motive," and "purpose," since the Board has made findings that the intention existed, and on that issue there is enough evidence to sustain its findings.

We come then to the question of the adequacy of the ceremonial acts, considered apart from the matter of intention. In searching for the correct legal rule to be used in reaching our answer, we are not here compelled by *Erie R. Co. v. Tompkins*, 304 U.S. 64, to play the role of ventriloquist's dummy to the courts of some particular state; as we understand it, "federal law," not "local law," is applicable.[4] See *Morgan v. Commissioner*, 309 U.S. 78, 80, 81, and the views of our leading tax commentator, 2 Paul, Federal Estate and Gift Taxes (1942) 1071–1078; cf. concurring opinion of Frankfurter, J., in *United States*

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1 Cf. United States v. Forness, 2 Cir., 1942, 125 F.2d 928, 934.

2 For similar comments as to consideration in the "law of contracts," see Havighurst, "Consideration, Ethics and Administration" 42 Col.L.Rev. 1 (1942).

3 Paul, Studies in Federal Taxation (1937) 150–153; Paul, 2 Federal Estate and Gift Taxation (1942) 1071; cf. Burnet v. Wells, 289 U.S. 670; Richardson v. Smith, 2 Cir., 1939, 102 F.2d 697, 698, 699, 125 A.L.R. 774; Richardson v. Commissioner, 2 Cir., 1941, 121 F.2d 1, 3.

4 Cf. Russell v. Todd, 309 U.S. 280, 287, 294.

v. Pink. We are free, therefore, not to insist on too much ritualism.[5] But, under all the authorities, there must be some.

There was here, prior to the enactment of the gift tax provisions, no physical delivery of the certificates to the donees nor any attempt to transfer them to their names on the books of Vicks Financial. We assume, arguendo, that the assignments in blank would have been adequate ceremonial gift conduct, if the assignments had been delivered to the respective donees or to their agent. Admittedly there was no such delivery to the donees. And the Board has found that, in connection with these transactions, Dawson—whether regarded as an individual or as representing Piedmont—was the agent of the donors, not of either of the donees.[6] The evidence on that point is equivocal; it is enough so that, having in mind the taxpayers' burden, we cannot hold that there is not ample evidence to sustain the Board's findings. And those findings likewise dispose of the entries on Piedmont's records, even assuming that those entries constituted a sufficient ritual (which they did not), since the Board found that Piedmont was not the agent, in these transactions, of either donee. Accordingly, we must affirm on the taxpayers' appeals.[7]

Notes and Problems

(A) In *Goodwin v. McGowan,* 47 F.Supp. 798 (W.D.N.Y.1942), it appeared that A had died in 1919, leaving a will by which he created a trust for his wife, B, for life, with remainder to such of the children of his son C as might be living on B's death. C had two children, D and E. In 1935, D transferred his interest irrevocably to a trustee for other persons. D paid a gift tax of $41,-582.59 on this transfer. D died in 1937 while B was still living. D's executor then filed a proper claim for refund of the gift tax, and brought suit for its recovery. What result?

(B) In *City Bank Farmers' Trust Co. v. Hoey,* 101 F.2d 9 (C.C.A.2d, 1939), and in *Commissioner v. Greene,* 119 F.2d 383 (C.C.A.9th, 1941), cert. den. 314 U.S. 641 (1941), noted in 41 Col.L.Rev. 1274 (1941), transfers made by the guardian or committee of an incompetent person, pursuant to court order, were held subject to the gift tax. Compare *City Bank Farmers' Trust Co. v. McGowan,* 323 U.S. 594 (1945), cited at p. 834 (B), above.

(C) T owned a remainder interest in a trust which he had assigned as security for certain notes. In 1939 he transferred

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[5] Cf. United States v. Forness, supra.

[6] That is to say the Board found that neither Dawson nor Piedmont was the agent of the donees in receiving the assignments.

[7] A portion of the opinion, relating to another gift is omitted.

In Rev.Rul. 54–554, 1954–2 Cum.Bull. 317, it was ruled that "Where the donor endorses a certificate of stock in favor of a donee and physically delivers the certificate to the donee or the donee's agent, the gift is completed for gift tax purposes on the date of delivery, even though the donee does not present the stock certificate to the corporation for transfer on its books until a later date."

his interest, subject to the assignment, to a trustee for his children. He believed that no gift tax was due because the outstanding debt was greater than the present value of his remainder. The trust instrument provided that if "it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax," then the trust should be ineffective, and the property should remain the sole property of T free from any trust. Is a gift tax due? *Commissioner v. Proctor,* 142 F. 2d 824 (C.C.A.4th, 1944), cert. den. 323 U.S. 756 (1944), noted in 58 Harv.L.Rev. 138 (1944). *Cf. Heaton v. Heaton,* 55 N.Y.S. 2d 154 (1945).

(D) In 1945, T transferred property to himself and his wife for their lives and the life of the survivor, with remainder to their three children. He did so under the advice of an attorney that this would take the property out of his estate for estate tax purposes. He filed a gift tax return reporting the gift. In 1947, he obtained further advice and learned that the transfer was not effective for the purpose of removing the property from his gross estate. In 1947 and early 1948, the wife and children reconveyed the property to him. Later in 1948, the Commissioner determined a deficiency in gift tax for 1945, because he valued the property higher than T had in his gift tax return, and because he eliminated exclusions taken with respect to the gifts to the children. In the Tax Court, T contended that no gift had been made, since the original transfer was conditional on its being effective to avoid the estate tax. The Tax Court sustained the tax, saying that "petitioner's disappointed hopes for estate tax relief" were "clearly insufficient to defeat the gift tax on an absolute and completed gift." *William H. Board,* 14 T.C. 322 (1950).

(E) The donor gives his own note. Is it then taxable, or only when paid? When is a gift of the donor's check taxable? See G.C.M. 16460, XV–1 C.B. 369 (1936).

(F) Does the tax apply to a gift of land outside of the United States? See sec. 2511(a) of the 1954 Code; *MacDonald v. United States,* 139 F.Supp. 598 (D.Mass.1956); *Lyman v. Commissioner,* 23 B.T.A. 540 (1931). Compare *Pearson v. McGraw,* 308 U.S. 313 (1939), referred to at p. 818 (B), *supra.*

(G) The Act under which nearly all federal bonds were issued prior to 1941 provided that such bonds "shall be exempt both as to principal and interest, from all taxation now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority, except (a) estate or inheritance taxes, and (b) graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes . . ." A gift of a bond issued under this Act was made on December 31, 1924. Is it taxable? *Hamersley v. United States,* 83 Ct.Cl. 687, 16 F.Supp. 768 (1936), cert. den. 300 U.S. 659 (1937), noted in 50 Harv.L.Rev. 840 (1937); *Phipps v. Commissioner,* 91 F.2d 627 (C.C.A.10th, 1937), cert. den. 302 U.S. 742 (1937).

No

(H) Is a gift by a corporation taxable? See sec. 25.2511–1 (h)(1) of the Gift Tax Regulations. Is a gift to a corporation taxable? Suppose the corporation is closely held and the other

shareholders are close relatives of the donor. See *Heringer v. Commissioner*, 235 F.2d 149 (C.A.9th, 1956); "Tax Consequences of Gifts of Property to Closely Held Corporations," 66 Harv. L.Rev. 334 (1952); "Taxation of Gifts to Closely Held Corporations," 57 Col.L.Rev. 240 (1957).

(I) Is a political campaign contribution subject to the gift tax? See Rev.Rul. 59–57, 1959–1 Cum.Bull. 626. Cf. Bloom, "Tax Results of Political Contributions," 34 Taxes 765 (1956).

E. T. 21

Bureau of Internal Revenue. 1948–2 Cum.Bull. 156.

Advice is requested whether, if husband and wife file a joint Federal income tax return, payment by either spouse of the entire income tax liability results in a transfer subject to gift tax.

It is held that where a joint Federal income tax return is filed by husband and wife the payment of the entire income tax liability by either spouse does not result in a transfer which is subject to gift tax.

Notes

(A) Medical and hospital bills were paid by the taxpayer for his adult son, and living expenses of the son's family were paid. The latter included monthly payments to cover the mortgage on the son's residence and automobile. These were held to constitute gifts in Rev.Rul. 54–343, 1954–2 Cum.Bull. 318.

Suppose a father has his son and the son's family over for Sunday dinner. Is this a gift? (The exclusion may have been consumed by other gifts made to the son.) How far is it desirable to keep books on hospitality? Where should the line be drawn in this situation?

(B) A husband irrevocably transferred insurance policies on his life to a trust. The trust provided that, after the grantor's death, his mother was to receive $3,000 a year for life, and the balance of the income was to go to his wife for life. After the wife's death, the income was to be paid to certain named relatives. Eventually, the remainder was to be divided up among the grantor's five brothers and sisters or their issue, per stirpes. After the transfer, the wife paid all the premiums on the policies. The Tax Court held that these were not gifts on the ground that there was no donative intent. This was reversed on appeal, the Court of Appeals holding that the portion of the premium in excess of the wife's interests in the policies was taxable as a gift, since the gift tax "should be construed to reach non-business transactions even in the absence of a donative intent where the effect otherwise would be to avoid both gift and estate taxes on the transfer of property." *Commissioner v. Berger,* 201 F.2d 171 (C.A.2d, 1953).

Disclaimers

(C) Suppose a testator dies, leaving a legacy to T. T disclaims the legacy with the result that it passes to some one else. Is this a gift by T? Compare *Brown v. Routzahn,* 63 F.2d 914 (C.C.A.6th, 1933), summarized at p. 829(D), above.

What would the situation be if T was not a legatee but an heir. Would a disclaimer by an heir be a gift? In *Hardenburgh v. Commissioner,* 198 F.2d 63 (C.A.8th, 1952), cert. den. 344 U.S. 836 (1952), it was held that such a disclaimer was a taxable gift. See also *William L. Maxwell,* 17 T.C. 1589 (1952).[1]

See, generally, Kay, "Renunciations, Disclaimers and Releases," 35 Taxes 767 (1957). See also sec. 25.2511-1(c) of the Gift Tax Regulations, and the discussion, before they were finally issued, in "Anticipated Problems under Proposed Treasury Regulations sec. 25.2511-1(c) (1957)," 30 Rocky Mountain L. Rev. 48 (1957).

In the British practice, a disclaimer is a transfer, so that if the person making the disclaimer dies within five years, it is taxable—as a gift in contemplation of death. See "Avoidance of estate duty by means of a disclaimer," [1957] British Tax Rev. 77.

ESTATE OF SANFORD v. COMMISSIONER

Supreme Court of the United States, 1939. 308 U.S. 39.

MR. JUSTICE STONE delivered the opinion of the Court.

This and its companion case, *Rasquin v. Humphreys,* p. 54, present the single question of statutory construction whether in the case of an *inter vivos* transfer of property in trust, by a donor reserving to himself the power to designate new beneficiaries other than himself, the gift becomes complete and subject to the gift tax imposed by the federal revenue laws at the time of the relinquishment of the power. Co-relative questions, important only if a negative answer is given to the first one, are whether the gift becomes complete and taxable when the trust is created or, in the case where the donor has reserved a power of revocation for his own benefit and has relinquished it before relinquishing the power to change beneficiaries, whether the gift first becomes complete and taxable at the time of relinquishing the power of revocation.

In 1913, before the enactment of the first gift tax statute of 1924, decedent created a trust of personal property for the benefit

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[1] For earlier discussion, with suggestions for changes in the statute, see Lauritzen, "Only God Can Make an Heir," 48 Northwestern U.L.Rev. 568 (1953). See also Roehner, "Renunciation as Taxable Gift—An Unconstitutional Federal Tax Decision," 8 Tax L.Rev. 289 (1953); 96 J. of Accountancy 350 (1953); 63 Harv.L.Rev. 1047 (1950); Canale and Cooper, "Will Renunciation of a Bequest or Failure to Claim a Statutory Share Constitute a Taxable Gift?" 2 Vand.L.Rev. 287 (1949); Bowe, "Gifts and Taxes," 18 U. of Cin.L.Rev. 287 (1949).

of named beneficiaries, reserving to himself the power to terminate the trust in whole or in part, or to modify it. In 1919 he surrendered the power to revoke the trust by an appropriate writing in which he reserved "the right to modify any or all of the trusts" but provided that this right "shall in no way be deemed or construed to include any right or privilege" in the donor "to withdraw principal or income from any trust." In August, 1924, after the effective date of the gift tax statute, decedent renounced his remaining power to modify the trust. After his death in 1928, the Commissioner following the decision in *Hesslein v. Hoey,* 91 F.2d 954, in 1937, ruled that the gift became complete and taxable only upon decedent's final renunciation of his power to modify the trusts and gave notice of a tax deficiency accordingly.

The order of the Board of Tax Appeals sustaining the tax was affirmed by the Court of Appeals for the Third Circuit, 103 F.2d 81, which followed the decision of the Court of Appeals for the second circuit in *Hesslein v. Hoey, supra,* in which we had denied certiorari, 302 U.S. 756. In the *Hesslein* case, as in the *Humphreys* case now before us, a gift in trust with the reservation of a power in the donor to alter the disposition of the property in any way not beneficial to himself, was held to be incomplete and not subject to the gift tax under the 1932 Act so long as the donor retained that power.

We granted certiorari in this case, 307 U.S. 618, and in the *Humphreys* case, *id.* 619, upon the representation of the Government that it has taken inconsistent positions with respect to the question involved in the two cases and that because of this fact and of the doubt of the correctness of the decision in the *Hesslein* case decision of the question by this Court is desirable in order to remove the resultant confusion in the administration of the revenue laws.

It has continued to take these inconsistent positions here, stating that it is unable to determine which construction of the statute will be most advantageous to the Government in point of revenue collected. It argues in this case that the gift did not become complete and taxable until surrender by the donor of his reserved power to designate new beneficiaries of the trusts. In the *Humphreys* case it argues that the gift upon trust with power reserved to the donor, not afterward relinquished, to change the beneficiaries was complete and taxable when the trust was created. It concedes by its brief that "a decision favorable to the government in either case will necessarily preclude a favorable decision in the other."

In ascertaining the correct construction of the statutes taxing gifts, it is necessary to read them in the light of the closely related provisions of the revenue laws taxing transfers at death, as

they have been interpreted by our decisions. Section 319 of the Revenue Act of 1924, 43 Stat. 253, reenacted as Sec. 501 of the 1932 Act, 47 Stat. 169, imposed a graduated tax upon gifts. It supplemented that laid on transfers at death, which had long been a feature of the revenue laws. When the gift tax was enacted Congress was aware that the essence of a transfer is the passage of control over the economic benefits of property rather than any technical changes in its title. See *Burnet v. Guggenheim,* 288 U. S. 280, 287. Following the enactment of the gift tax statute this Court in *Reinecke v. Northern Trust Company,* 278 U.S. 339 (1929) held that the relinquishment at death of a power of revocation of a trust for the benefit of its donor was a taxable transfer. *Cf. Saltonstall v. Saltonstall,* 276 U.S. 260; *Chase National Bank v. United States,* 278 U.S. 327, and similarly in *Porter v. Commissioner,* 288 U.S. 436 (1933), that the relinquishment by a donor at death of a reserved power to modify the trust except in his own favor is likewise a transfer of the property which could constitutionally be taxed under the provisions of section 302(d) of the 1926 Revenue Act (reenacting in substance 302(d) of the 1924 Act) although enacted after the creation of the trust. *Cf. Bullen v. Wisconsin,* 240 U.S. 625; *Curry v. McCanless,* 307 U.S. 357; *Graves v. Elliott,* 307 U.S. 383. Since it was the relinquishment of the power which was taxed as a transfer and not the transfer in trust, the statute was not retroactively applied. Cf. *Nichols v. Coolidge,* 274 U.S. 531; *Helvering v. Helmholz,* 296 U.S. 93, 98.

The rationale of decision in both cases is that "taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed" (see *Corliss v. Bowers,* 281 U.S. 376, 378; *Saltonstall v. Saltonstall, supra,* 261; *Burnet v. Guggenheim, supra,* 287) and that a retention of control over the disposition of the trust property, whether for the benefit of the donor or others, renders the gift incomplete until the power is relinquished whether in life or at death. The rule was thus established, and has ever since been consistently followed by the Court, that a transfer of property upon trust, with power reserved to the donor either to revoke it and recapture the trust property or to modify its terms so as to designate new beneficiaries other than himself is incomplete, and becomes complete so as to subject the transfer to death taxes only on relinquishment of the power at death.

There is nothing in the language of the statute, and our attention has not been directed to anything in its legislative history to suggest that Congress had any purpose to tax gifts before the donor had fully parted with his interest in the property given, or that the test of the completeness of the taxed gift was to be any different from that to be applied in determining whether the do-

nor has retained an interest such that it becomes subject to the estate tax upon its extinguishment at death. The gift tax was supplementary to the estate tax. The two are in *pari materia* and must be construed together. *Burnet v. Guggenheim, supra,* 286. An important, if not the main purpose of the gift tax was to prevent or compensate for avoidance of death taxes by taxing the gifts of property *inter vivos* which, but for the gifts, would be subject in its original or converted form to the tax laid upon transfers at death.

Section 322 of the 1924 Act provides that when a tax has been imposed by section 319 upon a gift, the value of which is required by any provision of the statute taxing the estate to be included in the gross estate, the gift tax is to be credited on the estate tax. The two taxes are thus not always mutually exclusive as in the case of gifts made in contemplation of death which are complete and taxable when made, and are also required to be included in the gross estate for purposes of the death tax. But section 322 is without application unless there is a gift *inter vivos* which is taxable independently of any requirement that it shall be included in the gross estate. Property transferred in trust subject to a power of control over its disposition reserved to the donor is likewise required by section 302(d) to be included in the gross estate. But it does not follow that the transfer in trust is also taxable as a gift. The point was decided in the *Guggenheim* case where it was held that a gift upon trust, with power in the donor to revoke it is not taxable as a gift because the transfer is incomplete, and that the transfer whether *inter vivos* or at death becomes complete and taxable only when the power of control is relinquished. We think, as was pointed out in the *Guggenheim* case, *supra,* 285, that the gift tax statute does not contemplate two taxes upon gifts not made in contemplation of death, one upon the gift when a trust is created or when the power of revocation, if any, is relinquished, and another on the transfer of the same property at death because the gift previously made was incomplete.

It is plain that the contention of the taxpayer in this case that the gift becomes complete and taxable upon the relinquishment of the donor's power to revoke the trust cannot be sustained unless we are to hold, contrary to the policy of the statute and the reasoning in the *Guggenheim* case, that a second tax will be incurred upon the donor's relinquishment at death of his power to select new beneficiaries, or unless as an alternative we are to abandon our ruling in the *Porter* case. The Government does not suggest, even in its argument in the *Humphreys* case, that we should depart from our earlier rulings, and we think it clear that we should not do so both because we are satisfied with the reasoning upon which they rest and because departure from either would produce inconsistencies in the law as serious and confusing

as the inconsistencies in administrative practice from which the Government now seeks relief.

There are other persuasive reasons why the taxpayer's contention cannot be sustained. By sections 315(b), 324, and more specifically by section 510 of the 1932 Act, the donee of any gift is made personally liable for the tax to the extent of the value of the gift if the tax is not paid by the donor. It can hardly be supposed that Congress intended to impose personal liability upon the donee of a gift of property, so incomplete that he might be deprived of it by the donor the day after he had paid the tax. Further, section 321(b)(1) exempts from the tax, gifts to religious, charitable, and educational corporations and the like. A gift would seem not to be complete, for purposes of the tax, where the donor has reserved the power to determine whether the donees ultimately entitled to receive and enjoy the property are of such a class as to exempt the gift from taxation. Apart from other considerations we should hesitate to accept as correct a construction under which it could plausibly be maintained that a gift in trust for the benefit of charitable corporations is then complete so that the taxing statute becomes operative and the gift escapes the tax even though the donor should later change the beneficiaries to the non-exempt class through exercise of a power to modify the trust in any way not beneficial to himself.

The argument of petitioner that the construction which the Government supports here, but assails in the *Humphreys* case, affords a ready means of evasion of the gift tax is not impressive. It is true, of course, that under it gift taxes will not be imposed on transactions which fall short of being completed gifts. But if for that reason they are not taxed as gifts they remain subject to death taxes assessed at higher rates, and the Government gets its due, which was precisely the end sought by the enactment of the gift tax. . . .

The question remains whether the construction of the statute which we conclude is to be derived from its language and history, should be modified because of the force of treasury regulations or administrative practice. Article I of Regulations 67, under the 1924 Act (adopted without any change of present significance in Article III, Regulations 79, under the 1932 Act) provides that the creation of a trust where the grantor retains the power to revest in himself title to the corpus of the trust does not constitute a gift subject to the tax and declares that "where the power retained by the grantor to revest in himself title to the corpus is not exercised, a taxable transfer will be treated as taking place in the year in which such power is terminated." Petitioner urges that the regulation is in terms applicable to the trust presently involved because it was subject to a power of revocation in favor of the donor before the enactment of the gift tax which was later relinquished.

But we think, as the court below thought, that the regulation was not directed to the case of the relinquishment of a reserved power to select new beneficiaries other than the donor and did not purport to lay down any rule for cases where there was a reserved power different from or in addition to the power to revest the title in the donor. At most the regulation is ambiguous and without persuasive force in determining the true construction of the statute. *Burnet v. Chicago Portrait Co.,* 285 U.S. 1, 16, 20. The amended regulation of 1936 under the 1932 Act, Art. III, Reg. 79, removed the ambiguity by declaring that the gift is complete and subject to the tax when "the donor has so parted with dominion and control as to leave in him no power to cause the beneficial title to be revested in himself." But this regulation is by its terms applicable only to gifts made after June 6, 1932, and is of significance here only so far as it is declaratory of the correct construction of the 1924 Act.

Petitioner also insists that the construction of the statute for which he contends is sustained by the administrative practice. That practice is not disclosed by any published Treasury rulings or decisions and our only source of information on the subject is a stipulation appearing in the record. It states that in the administration of the gift tax under the 1924 and 1932 Acts and until the decision in the *Hesslein* case it was "the uniform practice of the Commissioner of Internal Revenue in adjusting cases of the character of that here involved to treat the taxable transfer subject to gift tax as occurring when the transferor relinquished all power to revest in himself title to the property constituting the subject of the transfer"; and that three hundred cases "of such character" have been closed or adjusted in conformity to this practice. . . .

Such a stipulated definition of the practice is too vague and indefinite to afford a proper basis for a judicial decision which undertakes to state the construction of the statute in terms of the practice. Moreover, if we regard the stipulation as agreeing merely that the legal questions involved in the present case have uniformly been settled administratively in favor of the contention now made by the petitioner, it involves conclusions of law of the stipulators, both with respect to the legal issues in the present case and those resolved by the practice. We are not bound to accept, as controlling, stipulations as to questions of law. *Swift & Co. v. Hocking Valley Railway Co.,* 243 U.S. 281, 289.

Without attempting to say what the administrative practice has actually been we may, for present purposes, make the assumption most favorable to the taxpayer in this case that the practice was as stated by the Government in its brief in the *Humphreys* case, *viz.,* that until the decision in the *Hesslein* case "the Bureau consistently took the position that the gift tax applied to

a transfer in trust where the grantor reserved the right to modify the trust but no right to vest title in himself."

But the record here shows that no such practice was recognized as controlling in 1935 when the present case first received the attention of the Bureau. On February 21, 1935, the Assistant General Counsel gave an opinion reviewing at length the facts of the present case and the applicable principles of law, and concluded on the reasoning and authority of the *Guggenheim* and *Porter* cases that the gift was not complete and taxable until the relinquishment in August, 1924, of the power to modify the trust by the selection of new beneficiaries. In April, 1935, the matter was reconsidered and a new opinion was given which was finally adopted by the assistant secretary who had intervened in the case. This opinion reversed the earlier one on the authority of the *Guggenheim* case. It was at pains to point out that in that case the Court had held that the relinquishment of the power of revocation was a taxable gift but it made no mention of the fact that there, unlike the present case, there was no power of modification which survived the relinquishment of the power of revocation, which was crucial in the *Porter* case. Neither opinion rested upon or made any mention of any practice affecting cases where such a power of modification is reserved. After the decision in the *Hesslein* case the ruling of the Bureau in this case was again reversed and notice of deficiency sent to the taxpayer.

From this record it is apparent that there was no established administrative practice before the opinion of April, 1935, and if the practice was adopted then it was because of a mistaken departmental ruling of law based on an obvious misinterpretation of the decisions in the *Porter* and *Guggenheim* cases. . . .

The very purpose sought to be accomplished by judicial acceptance of an administrative practice would be defeated if we were to regard the present practice as controlling. If a practice is to be accepted because of the superior knowledge of administrative officers of the administrative needs and convenience, see *Brewster v. Gage,* 280 U.S. 327, 336, there is no such reason for its acceptance here. The Government by taking no position confesses that it is unable to say how administrative need and convenience will best be served. If, as we have held, we may reject an established administrative practice when it conflicts with an earlier one and is not supported by valid reasons, see *Burnet v. Chicago Portrait Co.,* 258 U.S. 1, 16, we should be equally free to reject the practice when it conflicts with our own decisions. A change of practice to conform to judicial decision, such as has occurred since the decision in the *Hesslein* case, or to meet administrative exigencies, will be accepted as controlling when consistent with our decisions. *Morrissey v. Commissioner,* 296 U.S. 344, 354. Here we have an added, and we think conclusive reason for

rejecting the earlier practice and accepting the later. The earlier, because in sharp conflict with our own decisions, as we have already indicated, cannot be continued without the perpetuation of inconsistency and confusion comparable to that of which the Government asks to be relieved by our decision.

Affirmed.

Notes and Problems

(A) At the same time, the case of *Rasquin v. Humphreys,* 308 U.S. 54 (1939), was decided. This involved a transfer made in December, 1934, in trust for the settlor for life with remainder to named persons. The settlor reserved the power to change the beneficiaries but not so as to increase his interest. It was held that the reserved power "rendered the gift incomplete and not subject to the gift tax."

(B) As held in *Burnet v. Guggenheim,* 288 U.S. 280 (1933), cited in the principal case, there is no tax on the creation of a revocable trust; but a gift is made when the power to revoke is terminated. See also Rev.Rul. 54–342, 1954–2 Cum.Bull. 315, where the grantor retained the income for life and power to appoint the remainder among certain named individuals and charities in such amounts as she might appoint. It was held that this was not a completed gift.

(C) *Power subject to consent of a person with an adverse beneficial interest.* Where there is a power to revoke or to modify, but only with the consent of a person having a substantial adverse beneficial interest, it has been held that a gift is made to the extent of that adverse interest, but not with respect to other interests in the transfer. See *Camp v. Commissioner,* 195 F.2d 999 (C.A.1st, 1952), for an excellent discussion.

In *Latta v. Commissioner,* 212 F.2d 164 (C.A.3d, 1954) the taxpayer created a trust in 1930. She reserved a power to modify or revoke only with the consent of her husband, who was then estranged, and who was later divorced. The husband was president of a company in which the trust had a large holding. In 1947, the wife released her power. It was held that the husband did not have an adverse interest, and that a gift was made in 1947.

(D) *Interim income.* In the case of a revocable trust, or of a *Porter* (or *Sanford* trust), is there a gift when each payment of income is actually made to the beneficiaries? It is now well established that there is a gift of the "interim income" in such cases. See *Commissioner v. Warner,* 127 F.2d 913 (C.C.A.9th, 1942). See also House Report No. 1079, 78th Congress, 2d Session, p. 68 (Amendment No. 199), on the 1943 Act.

(E) *Release of a donated power.* A husband created a trust providing that he and his wife might change the beneficiaries by joint action, with a similar power in the survivor after one died. The husband died. Thereafter the wife released the power. Is a gift tax due? See *Commissioner v. Solomon,* 124 F.2d 86 (C.C. A.3d, 1941). See also *Edith Evelyn Clark,* 47 B.T.A. 865 (1942).

(F) *Trust created with power in another to return the property.* A transferred property to T on trust to pay the income to

B for life with remainder to C. The trust instrument gave T power in his discretion to pay the income to A during his life. How much is taxable as a gift? *Herzog v. Commissioner,* 116 F.2d 591 (C.C.A.2d, 1941). See also *Alice Spaulding Paolozzi,* 23 T.C. 182 (1954), where the trustees had power to pay to the donor so much of the income as they might determine, in their absolute discretion, with remainder to others. Under Massachusetts law all of the income was in such a case subject to the claims of the donor's creditors. It was held that there was no gift of the interest for the donor's life. The *Herzog* case was distinguished.

But compare *Estate of Christianna K. Gramm,* 17 T.C. 1063 (1951), where a person created a trust giving the trustee power to invade the corpus of the trust for the comfort, education, maintenance and support of the settlor. It was held that it was not a completed transfer. The *Herzog* case was distinguished on the ground that the discretion given the trustee there was absolute.

(G) Can a gift be made though no "act" occurs at the time? Consider the following two cases:

(1) An infant made a transfer in trust, absolute on its face, on June 4, 1932. On October 9, 1933, the donor attained her majority. Is a gift tax due? See *Commissioner v. Allen,* 108 F.2d 961 (C.C.A.3d, 1939), cert. den. 309 U.S. 680 (1940), noted in 53 Harv.L.Rev. 690 (1940).

(2) W creates a trust of securities, and a second trust consisting of insurance policies on the life of her husband, H. The income of the first trust is used to pay the premiums on the policies in the second trust. Both trusts are revocable during the life of H. The beneficiaries of the second trust are children of H and W. H dies while W is still living. Does W make a gift? When? How much? See *Adele F. Goodman,* 4 T.C. 191 (1945), aff'd 156 F.2d 218 (C.C.A.2d, 1946).

SMITH v. SHAUGHNESSY

Supreme Court of the United States, 1943. 318 U.S. 176.

MR. JUSTICE BLACK delivered the opinion of the Court.

The question here is the extent of the petitioner's liability for a tax under §§ 501, 506 of the Revenue Act of 1932, 47 Stat. 169, which imposes a tax upon every transfer of property by gift, "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; . . ."

The petitioner, age 72, made an irrevocable transfer in trust of 3,000 shares of stock worth $571,000. The trust income was payable to his wife, age 44, for life; upon her death, the stock was to be returned to the petitioner, if he was living; if he was not living, it was to go to such persons as his wife might designate by will, or in default of a will by her, to her intestate successors under applicable New York law. The petitioner, under

protest paid a gift tax of $71,674.22, assessed on the total value of the trust principal, and brought suit for refund in the district court. Holding that the petitioner had, within the meaning of the Act, executed a completed gift of a life estate to his wife, the court sustained the Commissioner's assessment on $322,423, the determined value of her life interest; but the remainder was held not to be completely transferred and hence not subject to the gift tax. 40 F.Supp. 19. The government appealed and the Circuit Court of Appeals reversed, ordering dismissal of the petitioner's complaint on the authority of its previous decision in *Herzog v. Commissioner,* 116 F.2d 591. We granted certiorari because of alleged conflict with our decisions in *Helvering v. Hallock,* 309 U.S. 106, and *Estate of Sanford v. Commissioner,* 308 U.S. 39. In these decisions, and in *Burnet v. Guggenheim,* 288 U.S. 280, we have considered the problems raised here in some detail, and it will therefore be unnecessary to make any elaborate re-survey of the law.

Three interests are involved here: the life estate, the remainder, and the reversion. The taxpayer concedes that the life estate is subject to the gift tax. The government concedes that the right of reversion to the donor in case he outlives his wife is an interest having value which can be calculated by an actuarial device, and that it is immune from the gift tax. The controversy, then, reduces itself to the question of the taxability of the remainder.

The taxpayer's principal argument here is that under our decision in the *Hallock* case, the value of the remainder will be included in the grantor's gross estate for estate tax purposes; and that in the *Sanford* case we intimated a general policy against allowing the same property to be taxed both as an estate and as a gift.

This view, we think, misunderstands our position in the *Sanford* case. As we said there, the gift and estate tax laws are closely related and the gift tax serves to supplement the estate tax.[1] We said that the taxes are not "always mutually exclusive", and called attention to § 322 of the 1924 Act there involved (reenacted with amendments in § 801 of the 1932 Act) which charts the course for granting credits on estate taxes by reason of previous payment of gift taxes on the same property. The scope of that provision we need not now determine. It is sufficient to note here that Congress plainly pointed out that "some" of the "total gifts subject to gift taxes . . . may

[1] The gift tax was passed not only to prevent estate tax avoidance, but also to prevent income tax avoidance through reducing yearly income and thereby escaping the effect of progressive surtax rates. House Report No. 708, 72d Cong., 1st Sess. p. 28; Brandeis, J., dissenting in Untermyer v. Anderson, 276 U.S. 440, 450; Stone, J., dissenting in Heiner v. Donnan, 285 U.S. 312, 333.

be included for estate tax purposes and some not." House Report No. 708, 72d Cong., 1st Sess., p. 45. Under the statute the gift tax amounts in some instances to a security, a form of down-payment on the estate tax which secures the eventual payment of the latter; it is in no sense double taxation as the taxpayer suggests.

We conclude that under the present statute, Congress has provided as its plan for integrating the estate and gift taxes this system of secured payment on gifts which will later be subject to the estate tax.[2]

Unencumbered by any notion of policy against subjecting this transaction to both estate and gift taxes, we turn to the basic question of whether there was a gift of the remainder. The government argues that for gift tax purposes the taxpayer has abandoned control of the remainder and that it is therefore taxable, while the taxpayer contends that no realistic value can be placed on the contingent remainder and that it therefore should not be classed as a gift.

We cannot accept any suggestion that the complexity of a property interest created by a trust can serve to defeat a tax. For many years Congress has sought vigorously to close tax loop-holes against ingenious trust instruments.[3] Even though these concepts of property and value may be slippery and elusive they cannot escape taxation so long as they are used in the world of business. The language of the gift tax statute, "property . . . real or personal, tangible or intangible," is broad enough to include property, however conceptual or contingent. And lest there be any doubt as to the amplitude of their purpose, the Senate and House Committees, reporting the bill, spelled out their meaning as follows:

"The terms 'property,' 'transfer,' 'gift,' and 'indirectly' [in § 501] are used in the broadest sense; the term 'property' reaching every species of right or interest protected by the laws and having an exchangeable value." [4]

The Treasury regulations, which we think carry out the Act's purpose, made specific provisions for application of the tax to,

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[2] It has been suggested that the congressional plan relating to the estate and gift taxes may still be incomplete. See e. g., Griswold, A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions etc., 56 Harv. L.Rev. 337; Magill, The Federal Gift Tax, 40 Col.L.Rev. 773, 792; Kauper, The Revenue Act of 1942: Estate and Gift Tax Amendments, 41 Mich.L. Rev. 369, 388; and see Commissioner v. Prouty, 115 F.2d 331, 337; Higgins v. Commissioner, 129 F.2d 237, 239.

[3] 2 Paul, Federal Estate & Gift Taxation, Chap. 17; Schuyler, Powers of Appointment and Especially Special Powers: The Estate Taxpayer's Last Stand, 33 Ill.L.Rev. 771; Leaphart, The Use of the Trust to Escape the Imposition of Federal Income & Estate Taxes, 15 Corn.L.Q. 587.

[4] Senate Report No. 665, 72d Cong., 1st Sess., p. 39; House Report No. 708, supra, p. 29.

and determination of the value of, "a remainder . . . subject to an outstanding life estate." [5]

The essence of a gift by trust is the abandonment of control over the property put in trust. The separable interests transferred are not gifts to the extent that power remains to revoke the trust or recapture the property represented by any of them, *Burnet v. Guggenheim, supra,* or to modify the terms of the arrangement so as to make other disposition of the property, *Sanford v. Commissioner, supra.* In the *Sanford* case the grantor could, by modification of the trust, extinguish the donee's interest at any instant he chose. In cases such as this, where the grantor has neither the form nor substance of control and never will have unless he outlives his wife, we must conclude that he has lost all "economic control" and that the gift is complete except for the value of his reversionary interest.[6]

The judgment of the Circuit Court of Appeals is affirmed with leave to the petitioner to apply for modification of its mandate in order that the value of the petitioner's reversionary interest may be determined and excluded.

It is so ordered.

MR. JUSTICE ROBERTS.

I dissent. I am of opinion that, except for the life estate in the wife, the gift *qua* the donor was incomplete and not within the sweep of §§ 501 and 506. A contrary conclusion might well be reached were it not for *Helvering v. Hallock,* 309 U.S. 106. But the decisions in *Burnet v. Guggenheim,* 288 U.S. 280, and *Sanford v. Commissioner,* 308 U.S. 39, to which the court adheres, require a reversal in view of the ruling in the *Hallock* case. . . .

It will not square with logic to say that where the donor reserves the right to change beneficiaries, and so delays completion of the gift until his death or prior relinquishment of the right the gift is incomplete, but where he reserves a contingent interest to himself the reverse is true,—particularly so, if the criterion of estate tax liability is important to the decision of the question, as the *Sanford* case affirms.

The question is not whether a gift which includes vested and contingent future interests in others than the donor is taxable

5 Treas. Regulations 79 (1936 Ed.) Arts. 2, 3, 17, 19. Cf. Commissioner of Internal Revenue v. Marshall, 125 F.2d 943, 945.

6 The conclusion reached here is in accord with that of the several Circuit Courts of Appeal which have considered the problem: Commissioner v. Marshall, 125 F.2d 943 (C.C.A.2d); Commissioner v. Beck's Estate, 129 F.2d 243 (C.C.A.2d); Commissioner v. McLean, 127 F.2d 942 (C.C.A.5th); Helvering v. Robinette, 129 F.2d 832 (C.C.A.3d), affirmed by this Court today; Hughes v. Commissioner, 104 F.2d 144 (C.C.A.9th); and see the cases cited in Note (2), supra.

as an entirety when made, but whether a reservation of such an interest in the donor negatives a completion of the gift until such time as that interest is relinquished.

All that is said in the *Sanford* case about the difficulties of administration and probable inequities of a contrary decision there, applies here with greater force. Indeed a system of taxation which requires valuation of the donor's retained interest, in the light of the contingencies involved, and calculation of the value of the subsequent remainders by resort to higher mathematics beyond the ken of the taxpayer, exhibits the artificiality of the Government's application of the Act. . . .

Note and Problem

(A) On the same day the Court decided *Robinette v. Helvering,* 318 U.S. 184 (1943). The reversionary interests there involved were held to be incapable of valuation by recognized actuarial methods, with the result that no deduction was allowable in computing the gift tax.

(B) A husband gave land to his wife. Should the value of her inchoate right of dower be deducted in determining the value of the gift? See *Hopkins v. Magruder,* 34 F.Supp. 381 (D.Md.1940), noted in 54 Harv.L.Rev. 519 (1941), and 6 Md.L.Rev. 167 (1942).

Suppose a husband owns land and wants to sell it. His wife refuses to join in the deed unless she is paid for her inchoate dower interest. The husband makes such a payment to her. Is this a taxable gift? Compare *O'Malley v. Yost,* 189 F.2d 331 (C.A.8th, 1951), stated at p. 369(A), above.

The Treasury has ruled that there is no reduction in value because the wife has failed to release inchoate dower. Rev.Rul. 58–13, 1958–1 Cum.Bull. 342.

COMMISSIONER v. HOGLE

United States Circuit Court of Appeals, Tenth Circuit, 1947. 165 F.2d 352.

PHILLIPS, CIRCUIT JUDGE. The Commissioner assessed gift taxes against Hogle for the years 1936 to 1941, inclusive. On review, the Tax Court held there were no deficiencies in gift taxes for those years.

The question presented is whether or not annual earnings of two trusts, one known as the Copley Trust, and one known as the Three Trust, during the years in question, from trading in securities and commodities carried on by the trusts under Hogle's direction, amounted to gifts by Hogle to the trusts. These trusts were before this court in *Hogle v. Commissioner,* 10 Cir., 132 F. 2d 66, and the facts with respect to such trusts are there fully set out.

The Copley Trust was created in 1922 by Hogle and his wife for the benefit of their three children. It consisted of a securi-

ties trading account to be managed and operated under Hogle's direction, the property accruing to the trust to be divided among the children on April 15, 1945. The trust was irrevocable and Hogle retained no right to alter or amend the trust instrument, or to change the beneficial interests. None of the principal or income could revest in Hogle. It provided that any losses resulting from trading in excess of the "profits and various income returns thereof" should be made good by Hogle, and that any such losses should not become an indebtedness of the trustee or the beneficiaries, but that any such losses made good by Hogle should be returned to him out of the first profits that accrued from further transactions.

On October 7, 1922, a margin account was opened for the trust with J. A. Hogle & Company, a brokerage partnership, consisting of Hogle and his wife, and in which the three children subsequently became partners. The trading resulted in profits in every year, except 1928 and 1929. In those years, certain securities were given to the trust by Hogle and his wife. The profits and benefits in the trust were divided on April 15, 1945, among the three children, and the trust was terminated.

In 1932, Hogle opened a trading account with the partnership in the name of the Three Trust account and a few days thereafter, Hogle and his wife created the Three Trust, consisting of a securities trading account for the benefit of the three children. The trust was irrevocable and was in all respects like the Copley Trust, with the exception it was to terminate on April 15, 1950, and income could be distributed in the meantime in the discretion of Hogle and any two of the three trustees. Although the trading was conducted in the name of the trust, receipts and disbursements were credited and debited to the individual beneficiaries according to the specified share of each during the term of the trust. Gains and profits were realized in every year, including the taxable years.

The net worth of each trust in each of the years for which the gift taxes were assessed was more than sufficient to provide the margins required to cover the trading carried on for it.

In *Hogle v. Commissioner,* supra, we held, under the doctrine of *Helvering v. Clifford,* 309 U.S. 331, that the net income resulting from trading on margin was taxable to Hogle. We do not think it follows, however, that the net income in each of the taxable years derived from trading constituted a gift thereof by Hogle to the trusts.

Section 501 of the Revenue Act of 1932, 47 Stat. 169, as amended by § 511 of the Revenue Act of 1934, 48 Stat. 680, imposed a tax upon the transfer, during the calendar year, of property by gift. Section 1000 of the Internal Revenue Code, contains a sub-

stantially identical provision and it applies to the calendar year 1940 and subsequent calendar years. And Article 2, Treasury Regulations 79, provides among other things that a gift tax is imposed whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; and further, that the tax applies to all transactions whereby property or property rights or interests are donatively passed or conferred upon another. The purpose of the statute is to reach and lay a tax upon every type and kind of transfer of property by gift.[1] With that legislative purpose in mind, the terms "property," transfer," "gift," and "indirectly," as used in the statute, should be interpreted in their broadest and most comprehensive sense.[2] But the tax cannot be sustained unless there was a transferor, a transferee, and an effective transfer of title or other economic interest or benefit in property having the quality of a gift.

The net income derived from trading carried on in behalf of the trusts accrued immediately and directly to the trusts, and did not consist of income accruing to Hogle which he transferred by anticipatory gift to the trusts. Hogle never owned or held an economic interest in such income. Likewise, since the funds in the trusts were sufficient to provide the margins required to cover the trading carried on in the taxable years, any losses resulting from trading would have been suffered immediately and directly by the trusts. What, in fact and in reality, Hogle gave to the trusts in the taxable years was his expert services in carrying on the trading, personal services in the management of the trust. Hogle could give or withhold his personal services in carrying on trading on margin for the trusts. He could not withhold from the trusts any of the income accruing from trading on margin. How could he give what he could not withhold? There was no transfer directly or indirectly from Hogle to the trusts of title to, or other economic interest in, the income from trading on margin, having the quality of a gift. In short, there was no transfer directly or indirectly by Hogle to the trusts of property or property rights.

The Commissioner places strong reliance upon *Hogle v. Commissioner,* supra, to sustain the contention that the income arising from the trading on margin represented personal earnings of Hogle; and that Hogle in substance gave to the trusts the profits derived from part of his individual efforts. Certain excerpts from the opinion are emphasized in support of the argument that the net income arising from the trading on margin for the benefit of the trusts represented earnings of Hogle, and that,

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1 Robinette v. Helvering, 318 U.S. 184, 187.

2 Smith v. Shaughnessy, 318 U.S. 176, 180; Commissioner v. Wemyss, 324 U.S. 303, 306.

upon the accrual of such income to the trusts, a transfer having the quality of a gift was effectuated within the meaning of §§ 501 and 1000, supra. But, we think a critical reading of the opinion in that case in its entirety will indicate that it does not support the Commissioner's contention. While the court drew a distinction between the income tax liability of Hogle on profits accruing to the trusts from trading on margin and gains accruing to the trusts from other sources, and held that he was liable for the tax on net income derived from such trading but not on gains accruing from other sources, his liability for tax on the net income derived from trading on margin was predicated upon his power to control indirectly the extent of the profit derived from such trading by determining the extent and amount of such trading. Despite certain statements contained in the opinion on which the Commissioner relies, the basis of the holding that Hogle was liable for income tax on the net income resulting from trading on margin was his power to control the extent of such trading and therefore the extent of the income therefrom. It was predicated on his power to dominate the amount of income that would accrue from trading. That was the essence of our holding. We did not hold that such income accrued first to Hogle and was by him transferred by anticipatory gift to the trusts.

Our holding in *Hogle v. Commissioner,* supra, was an extreme application of the doctrine of the *Clifford* case, supra. To hold that the profits accruing from trading in margins constitute gifts from Hogle to the trusts, we think, would be an unjustified extension of the doctrine of the *Clifford* case.

Affirmed.

HUXMAN, CIRCUIT JUDGE, concurs in the result.[3]

Problem

A man creates a funded insurance trust. See *Burnet v. Wells,* at page 267, above. Is the entire value of the property transferred subject to gift tax? *Commissioner v. Beck,* 129 F.2d 243 (C.C.A.2d, 1942).

For a treatment of special problems, see Thurman, "Federal Estate and Gift Taxation of Community Property Life Insurance," 9 Stanford L.Rev. 239 (1957).

GALT v. COMMISSIONER

United States Court of Appeals, 7th Circuit, 1954. 216 F.2d 41.

[The taxpayer was the owner of a race track. On February 26, 1946, he leased it to a trotting association for twenty years. The terms of the lease provided for a fixed rent, plus a percent-

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3 There is a comment on the Hogle case in 57 Yale L.J. 1122 (1948). See also Brunner, "Donor's Income Tax Liability as Subjecting Him to Subsequent Gift Tax," 25 Taxes 813 (1947).

age of the amount wagered at the race track. It was provided that a portion of the percentage rental should be paid direct to each of the taxpayer's three sons. Under this provision $23,923.-83 was paid to each son on October 22, 1946.

This gave rise to two cases, which were tried together. One was an income tax case. This is summarized in paragraph (D) on p. 227, above. The other was a gift tax case, for 1946. The Commissioner had great difficulty in determining whether the gift was a single gift made on the date of the lease, or was a series of successive annual gifts.]

MAJOR, CHIEF JUDGE. . . . At the inception of the hearing before the Tax Court, the Commissioner shifted his position on the gift tax issue by disclaiming the theory on which his deficiency had been asserted, that is, that petitioner made a gift to his sons on February 26, 1946, and advancing instead the theory that a gift was made during the year in the amount of $23,923.83. The Tax Court embraced this theory in its decision and found that petitioner made gifts to his sons during the year 1946, without finding the date on which the gifts were made. While not expressly stated, it is evident that the Tax Court's decision must rest upon the implied finding that the gifts were made on October 22, 1946. Petitioner before the Tax Court also shifted his position, not upon the crucial issue as to when gifts were made to his sons, but upon their value. As already noted, in his gift tax return he asserted that the gifts were made on February 26, 1946, and that they had no value. At the hearing before the Tax Court, he still maintained that they were made on that date but contended that they had a value, in fact, proved by two expert witnesses that their value on that date was $34,090.00. Thus, there is no contested issue over the fact that petitioner made a gift to his sons during the year 1946. The controversy now is whether the Tax Court correctly refused to decide that petitioner made gifts to his sons on February 26, 1946, and to determine the value of the gifts as of that date. Or, conversely, did the Tax Court correctly decide that petitioner made gifts to his sons in 1946, without determining the date of such gifts, although presumably they were found to have been made on October 22, 1946, with a value in the exact amount as was paid to the sons by Maywood Park on that date? . . .

We have heretofore set forth the position which the parties originally took with reference to the gift tax issue. The Tax Court, after setting forth the facts relevant thereto, in its opinion stated:

"At the trial he [Commissioner] stated that he no longer contended that petitioner's gifts were made at the time of the assignment; as to that contention he conceded error, and he assumed

the basic position that petitioner made gifts to his sons each year as, and in the amounts that, the rentals were paid to them year by year. Respondent now must be taken to admit, therefore, that a gift tax deficiency for 1946 in the amount of $68,079 is excessive, and that a deficiency is owing for that year only to the extent of the tax due on gifts valued at $23,923.83. . . . On the other side, petitioner now insists that gifts were made in 1946, and that they were made once and for all when the sons were given an interest in the rents; that the gifts, as then made, can be valued and that their total value was $34,090; and that petitioner owes a gift tax for 1946 based on that valuation." The Tax Court then proceeds to decide the issue as follows:

"Because of the concessions of the parties, and because only the year 1946 is before us in this proceeding, it becomes unnecessary to consider when, and of what value, the gift was made. Respondent now seeks a gift tax for 1946, based on a maximum valuation of $23,923.83. That is all the Government is asking for, and it is therefore not entitled to an award in a greater amount. Accordingly, since petitioner admits that he owes a gift tax based upon a gift of $34,090, and since respondent now claims to be entitled only to a tax based upon a gift in the amount of $23,923.83, we must hold that the latter amount is the measure of petitioner's gift tax liability for 1946."

No case is cited either by the Tax Court in its opinion or by respondent in his brief in support of the result reached on this issue. The Commissioner concludes his argument, attempting to justify his shift in position, with the following statement:

"The significant thing in this case is that the Commissioner, when the controversy as to the two taxes finally reached trial before the Tax Court, upon a re-examination of his position, then determined to adhere to the position which seemed to him proper, namely to assert that the taxpayer was liable for an income tax upon the amounts paid to the sons in 1946 because that constituted taxable income to him and to assert that the taxpayer was liable for a gift tax for 1946 to the extent of the amounts paid to the sons in that year."

It is argued that the taxpayer has not been harmed inasmuch as he conceded that a gift was made in 1946 of a value greater than that claimed by respondent and that appears to have been the basis for the Tax Court's decision. We assume that ordinarily a party is in no position to complain where he is required by judgment or otherwise to pay a sum of money less than he admittedly owes. But there is more than that involved in this situation and the holding of the Tax Court overlooks the plain realities of the situation. While the court did not expressly so state, it is implicit in its holding that petitioner would be liable each succeeding year for a gift tax upon amounts paid to his

sons under the terms of the lease. In fact, that was respondent's contention before the Tax Court, as shown in the quotation first above made from the opinion of the Tax Court, wherein it is stated that respondent "assumed the basic position that petitioner made gifts to his sons each year as, and in the amounts that, the rentals were paid to them year by year." This incongruous result would be in prospect notwithstanding the fact that petitioner committed no affirmative act with reference to payments to his sons other than that performed on February 26, 1946, when the assignments were made.

We think petitioner was entitled to a decision on his contention that a gift was made on February 26, 1946, a position which he maintained from the beginning to the present, in which the respondent originally acquiesced and a position upon which his deficiency was asserted. In view of that contention by petitioner, we think it unnecessary to determine whether a completed gift was made at that time or any other, which eliminates the necessity for any consideration as to whether the gift was irrevocable. It appears to be the position of respondent that a holding that the gift was made at the time of the execution of the lease would be inconsistent with the decision that petitioner received income when payments were made to his sons. This suggestion ignores the difference between a gift taxable as such and the receipt of income for tax purposes. A gift tax is imposed not upon property but upon its transfer, while an income tax is imposed upon income at the time of its realization. To hold as we have that petitioner realized income when payments were made to his sons in October is not, as we think, inconsistent with a holding that petitioner made a gift to his sons in the previous February when the lease was executed.

It is our view that the gift, conceded by all parties to have been made in 1946, was made on February 26, as urged by petitioner. To think otherwise is to ignore the plain, unambiguous terms of the statute, as well as the regulations promulgated in connection therewith. Sec. 1000(b) of the [1939] Internal Revenue Code. . . .

We think it is hardly open to dispute but that petitioner's sons as donees at the time of the execution of the lease and assignments acquired a property right, that is, a right to receive income, a right to participate in the rental proceeds. The manner of the enforcement of that right or what it might mean to the donees in the future is of no consequence. . . .

Returning to *Helvering v. Horst,* 311 U.S. 112, while the sole question decided was that the money received by the son from collection of the interest coupons was income chargeable to the father, the court recognizes that a gift was previously made and

at the time when the coupons were delivered to the son. While the question was not before the court, it appears hardly open to doubt but that the father would have been subject to a gift tax upon the transfer or delivery of the coupons and that the value upon which the tax could have been imposed was that at the time of delivery rather than at the time of maturity when the son collected the coupons. Obviously, of course, the value of the gift in that case was more readily ascertainable than in the present case, but the fact that the value of the gift is difficult of ascertainment is not material, as we have shown.

Holding as we do that the gift in controversy was made by petitioner to his sons on February 26, 1946, there remains the question as to whether the proceeding should be remanded to the Tax Court for the purpose of finding its value. Ordinarily we would be disposed to so do in order that the Commissioner might have an opportunity to offer proof as to the value of the gift when made. However, this is not an ordinary situation. Petitioner by expert witnesses proved that the value of the gift when made was $34,090. Respondent had an opportunity but refused to offer evidence on this issue. Instead, he deliberately shifted his position for the purpose stated in his brief, "in order to protect the revenue." In view of our conclusion, it is evident that the Commissioner mounted a horse headed in the wrong direction. Such being the case, it is not discernible why petitioner should be put to the expense and vexation of another hearing on an issue which he sought to maintain and upon which he offered proof. The uncontroverted evidence is that the value of the gift when made was $34,090, which we under the circumstances accept as its value.

The decision of the Tax Court . . . as to the deficiency in the petitioner's gift tax for the year 1946 is reversed and remanded, with directions that the deficiency in that respect be redetermined on the basis of this decision.

Problems

(A) What position should the Commissioner have taken with respect to the gift tax? Assuming that the issue was properly raised by pleadings and evidence, how should the gift tax question be decided?

(B) What is the effect of this decision as res judicata? May the Commissioner contend that the rental payments made to the sons in 1947 and later years are gifts in each of those years? Should the Commissioner have given more weight to the possible effect of res judicata in determining the position he would take on the gift tax issue? Is there any reason why the Commissioner's contentions on this issue could not have been presented in the alternative?

(C) In 1944, T entered into a separation agreement with his wife which contained provisions for his children (then 20 and 14

years of age) covering the period after they became 21 years old as well as before that time, most of which consisted of an obligation to set up trusts for the children if T's mother died during his lifetime. Later that year, this agreement was incorporated into a Nevada divorce decree. T's mother did die in 1945, while T was still living. The value of the obligation to the children in this agreement was $499,340.98. In 1945, T sought to enter into a new agreement by which he could pay a lump sum in discharge of his obligation. After negotiations, this resulted in a new agreement made in 1946. The total obligation assumed in this new agreement was $729,737.67. This was approved by the Nevada court and $640,042.66 was paid by T in 1946.

T did not return anything for gift tax purposes for 1944, since the amounts actually paid in that year were relatively small and were within his obligation to support his minor children. He paid a gift tax of $160,212 on the amount paid in 1946. The Commissioner determined a deficiency for 1946 on the ground that the obligation to make certain future payments in later years was also taxable as a gift in 1946. The taxpayer petitioned the Tax Court, and sought a refund of the gift tax he had paid for 1946 on the ground that the obligations assumed in that year were for consideration, since they were undertaken for a release of the prior obligation under the 1944 agreement. The taxpayer's 1944 gift tax return was also before the Tax Court at the same time because of a claimed deficiency based on payments to the wife under the 1944 agreement.

The Tax Court held that the gift was made in 1946, and determined a deficiency for that year. It also determined a deficiency for 1944, based only on payments to the wife. Neither party sought review of the decision for 1944. T filed a petition to review the decision as to 1946. The Court of Appeals held that the original promise was taxable in 1944, at its value, and that the release of this obligation in 1946 constituted consideration for the promise made in 1946. Accordingly it held that no gift tax was due for 1946, except to the extent that the consideration was inadequate to support the promises made in 1946. It directed the Tax Court to expunge the deficiency if it found that "the 1946 agreement does represent the fruits of a bona fide arm's length transaction without donative intent." Since neither side had appealed the decision as to 1944, the court held that that decision had become final, and no additional tax could be determined for that year. *Rosenthal v. Commissioner,* 205 F.2d 505 (C.A.2d, 1953). See "Alternative Tax Years and the Requirement of Cross Appeal: A Procedural Check to Gift Tax Evasion," 63 Yale L.J. 243 (1953).

COMMISSIONER v. WEMYSS

Supreme Court of the United States, 1945. 324 U.S. 303.

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

In 1939 taxpayer proposed marriage to Mrs. More, a widow with one child. Her deceased husband had set up two trusts, one half the income of which was for the benefit of Mrs. More and the other half for that of the child with provision that, in

the event of Mrs. More's remarriage, her part of the income ceased and went to the child. The corpus of the two trusts consisted of stock which brought to Mrs. More from the death of her first husband to her remarriage, about five years later, an average income of $5,484 a year. On Mrs. More's unwillingness to suffer loss of her trust income through remarriage the parties on May 24, 1939, entered upon an agreement whereby taxpayer transferred to Mrs. More a block of shares of stock. Within a month they married. The Commissioner ruled that the transfer of this stock, the value of which, $149,456.13, taxpayer does not controvert, was subject to the Federal Gift Tax, §§ 501 and 503 of the Revenue Act of 1932, 47 Stat. 169, 245, 247, 26 U.S.C. §§ 1000, 1002. Accordingly, he assessed a deficiency which the Tax Court upheld, 2 T.C. 876, but the Circuit Court of Appeals reversed the Tax Court, 144 F.2d 78. We granted certiorari to settle uncertainties in tax administration engendered by seemingly conflicting decisions.

The answer to our problem turns on the proper application of §§ 501(a) and 503 *supra* to the immediate facts. These provisions are as follows:

> "Sec. 501. Imposition of Tax
>
> "(a) For the calendar year 1932 and each calendar year thereafter a tax, computed as provided in section 502, shall be imposed upon the transfer during such calendar year by any individual . . . of property by gift."
>
> "Sec. 503. Transfers for less than adequate and full consideration
>
> "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this title, be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year."

In view of the major rôle which the Tax Court plays in federal tax litigation, it becomes important to consider how that court dealt with this problem. Fusing, as it were, §§ 501 and 503, the Tax Court read them as not being limited by any common law technical notions about "consideration". And so, while recognizing that marriage was of course a valuable consideration to support a contract, the Tax Court did not deem marriage to satisfy the requirement of § 503 in that it was not a consideration reducible to money value. Accordingly, the Court found the whole value of the stock transferred to Mrs. More taxable under the statute and the relevant Treas.Reg. 79 (1936) Art. 8: "A consideration not reducible to a money value, as love and affection, promise of marriage, etc., is to be wholly disregarded,

and the entire value of the property transferred constitutes the amount of the gift." In the alternative, the Tax Court was of the view that if Mrs. More's loss of her trust income rather than the marriage was consideration for the taxpayer's transfer of his stock to her, he is not relieved from the tax because he did not receive any money's worth from Mrs. More's relinquishment of her trust income, and, in any event, the actual value of her interest in the trust, subject to fluctuations of its stock earnings, was not proved. One member of the Tax Court dissented, deeming that the gift tax legislation invoked ordinary contract conceptions of "consideration".

The Circuit Court of Appeals rejected this line of reasoning. It found in the marriage agreement an arm's length bargain and an absence of "donative intent" which it deemed essential: "A donative intent followed by a donative act is essential to constitute a gift; and no strained and artificial construction of a supplementary statute should be indulged to tax as a gift a transfer actually lacking donative intent." 144 F.2d 78, 82.

Sections 501 and 503 are not disparate provisions. Congress directed them to the same purpose, and they should not be separated in application. Had Congress taxed "gifts" *simpliciter,* it would be appropriate to assume that the term was used in its colloquial sense, and a search for "donative intent" would be indicated. But Congress intended to use the term "gifts" in its broadest and most comprehensive sense. H.Rep.No.708, 72d Cong., 1st Sess., p. 27; S.Rep.No.665, 72d Cong., 1st Sess., p. 39; cf. *Smith v. Shaughnessy,* 318 U.S. 176; *Robinette v. Helvering,* 318 U.S. 184. Congress chose not to require an ascertainment of what too often is an elusive state of mind. For purposes of the gift tax it not only dispensed with the test of "donative intent." It formulated a much more workable external test, that where "property is transferred for less than an adequate and full consideration in money or money's worth," the excess in such money value "shall, for the purpose of the tax imposed by this title, be deemed a gift . . .". And Treasury Regulations have emphasized that common law considerations were not embodied in the gift tax.[1]

To reinforce the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech, the Treasury Regulations make clear that no genuine business transaction comes within the purport of the gift tax by excluding

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1 Treas.Reg. 79 (1936) ed.) Art. 1: "*Imposition of tax.*— . . . The tax is not limited in its imposition to transfers of property without a valuable consideration, which at common law are treated as gifts, but extends to sales and exchanges for less than an adequate and full consideration in money or money's worth."

"a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is *bona fide,* at arm's length, and free from any donative intent)." Treas.Reg. 79 (1936 ed.) Art. 8. Thus on finding that a transfer in the circumstances of a particular case is not made in the ordinary course of business, the transfer becomes subject to the gift tax to the extent that it is not made "for an adequate and full consideration in money or money's worth". See 2 Paul, Federal Estate and Gift Taxation (1942) p. 1113.

The Tax Court in effect found the transfer of the stock to Mrs. More was not made at arm's length in the ordinary course of business. It noted that the inducement was marriage, took account of the discrepancy between what she got and what she gave up, and also of the benefit that her marriage settlement brought to her son. These were considerations the Tax Court could justifiably heed, and heeding, decide as it did. Its conclusion on the issue before it was no less to be respected than were the issues which we deemed it was entitled to decide as it did in *Dobson v. Commissioner,* 320 U.S. 489, *Commissioner v. Heininger,* 320 U.S. 467, *Commissioner v. Scottish American Co.,* 323 U.S. 119.

If we are to isolate as an independently reviewable question of law the view of the Tax Court that money consideration must benefit the donor to relieve a transfer by him from being a gift, we think the Tax Court was correct. See *Commissioner v. Bristol,* 121 F.2d 129. To be sure, the Revenue Act of 1932 does not spell out a requirement of benefit to the transferor to afford relief from the gift tax. Its forerunner, § 320 of the 1924 Act, 43 Stat. 253, 314, was more explicit in that it provided that the excess of the transfer over "the consideration received shall . . . be deemed a gift." It will hardly be suggested, however, that in reimposing the gift tax in 1932 Congress meant to exclude transfers that would have been taxed under the 1924 Act. The section taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers which are withdrawn from the donor's estate. To allow detriment to the donee to satisfy the requirement of "adequate and full consideration" would violate the purpose of the statute and open wide the door for evasion of the gift tax. See 2 Paul, *supra* at 1114.

Reversed.

MR. JUSTICE ROBERTS dissents.

Notes

(A) On the same day the court decided *Merrill v. Fahs,* 324 U.S. 308 (1945), which began as a suit against a collector in a district court. In the *Merrill* case, the transfer was by an ante-

nuptial agreement which became effective only on the celebration of the marriage, and by which the prospective wife released all her rights as wife or widow in the prospective husband's property. The Court held that the transfer was taxable in full as a gift. The cases are discussed in Rand, "What is a Gift?" 34 Ky.L.Rev. 99 (1946).

(B) In *Estate of Monroe D. Anderson,* 8 T.C. 706 (1947), stock was transferred to a business associate, not a relative, in an arm's length transaction, but for a figure which was found to be less than its fair market value. It was held that it was not a gift. The *Wemyss* case was distinguished on the basis of the language in the second and third paragraphs from the end of the opinion. The Commissioner has acquiesced in this decision. 1947–2 Cum.Bull. 1.

HARRIS v. COMMISSIONER

Supreme Court of the United States, 1950. 340 U.S. 106.

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

The federal estate tax and the federal gift tax, as held in a line of cases ending with *Commissioner v. Wemyss,* 324 U.S. 303, and *Merrill v. Fahs,* 324 U.S. 308, are construed *in pari materia,* since the purpose of the gift tax is to complement the estate tax by preventing tax-free depletion of the transferor's estate during his lifetime. Both the gift tax [sec. 1002] and the estate tax [sec. 812(b)(4)] exclude transfers made for "an adequate and full consideration in money or money's worth." In the estate tax this requirement is limited to deductions for claims based upon "a promise or agreement;" but the consideration for the "promise or agreement" may not be the release of marital rights in the decedent's property. In the *Wemyss* and *Merrill* cases the question was whether the gift tax was applicable to premarital property settlements. If the standards of the estate tax were to be applied *ex proprio vigore* in gift tax cases, those transfers would be taxable because there was a "promise or agreement" touching marital rights in property. We sustained the tax, thus giving "adequate and full consideration in money or money's worth" the same meaning under both statutes insofar as premarital property settlements or agreements are concerned.

The present case raises the question whether *Wemyss* and *Merrill* require the imposition of the gift tax in the type of postnuptial settlement of property rights involved here.

Petitioner divorced her husband, Reginald Wright, in Nevada in 1943. Both she and her husband had substantial property interests. They reached an understanding as respects the unscrambling of those interests, the settlement of all litigated claims to the separate properties, the assumption of obligations, and the transfer of properties.

Wright received from petitioner the creation of a trust for his lifetime of the income from her remainder interest in a then existing trust; an assumption by her of an indebtedness of his of $47,650; and her promise to pay him $416.66 a month for ten years.

Petitioner received from Wright 21/90 of certain real property in controversy; a discontinuance of a partition suit then pending; an indemnification from and assumption by him of all liability on a bond and mortgage on certain real property in London, England; and an indemnification against liability in connection with certain real property in the agreement. It was found that the value of the property transferred to Wright exceeded that received by petitioner by $107,150. The Commissioner assessed a gift tax on the theory that any rights which Wright might have given up by entering into the agreement could not be adequate and full consideration.

If the parties had without more gone ahead and voluntarily unravelled their business interests on the basis of this compromise, there would be no question but what the gift tax would be payable. For there would have been a "promise or agreement" that effected a relinquishment of marital rights in property. It therefore would fall under the ban of the provision of the estate tax which by judicial construction has been incorporated into the gift tax statute.

But the parties did not simply undertake a voluntary contractual division of their property interests. They were faced with the fact that Nevada law not only authorized but instructed the divorce court to decree a just and equitable disposition of both the community and the separate property of the parties.[6] The agreement recited that it was executed in order to effect a settlement of the respective property rights of the parties "in the event a divorce should be decreed;" and it provided that the agreement should be submitted to the divorce court "for its approval." It went on to say, "It is of the essence of this agreement that the settlement herein provided for shall not become operative in any manner nor shall any of the recitals or covenants herein become binding upon either party unless a decree of absolute divorce between the parties shall be entered in the pending Nevada action."

If the agreement had stopped there and were in fact submitted to the court, it is clear that the gift tax would not be applicable.

[6] At the time of the divorce Nevada Compiled Laws, § 9463 provided: "In granting a divorce the court may award such alimony to the wife and shall make such disposition of the community and separate property of the parties as shall appear just and equitable, having regard to the respective merits of the parties and to the condition in which they will be left by such divorce, and to the party through whom the property was acquired, and to the burdens, if any, imposed upon it for the benefit of the children. . . ."

That arrangement would not be a "promise or agreement" in the statutory sense. It would be wholly conditional upon the entry of the decree; the divorce court might or might not accept the provisions of the arrangement as the measure of the respective obligations; it might indeed add to or subtract from them. The decree, not the arrangement submitted to the court, would fix the rights and obligations of the parties. That was the theory of *Commissioner v. Maresi*, 156 F.2d 929, and we think it sound.

Even the Commissioner concedes that that result would be correct in case the property settlement was litigated in the divorce action. That was what happened in *Commissioner v. Converse*, 163 F.2d 131, where the divorce court decreed a lump sum award in lieu of monthly payments provided by the separation agreement. Yet without the decree there would be no enforceable, existing agreement whether the settlement was litigated or unlitigated. Both require the approval of the court before an obligation arises. The happenstance that the divorce court might approve the entire settlement, or modify it in unsubstantial details, or work out material changes seems to us unimportant. In each case it is the decree that creates the rights and the duties; and a decree is not a "promise or agreement" in any sense—popular or statutory.

But the present case is distinguished by reason of a further provision in the undertaking and in the decree. The former provided that "the covenants in this agreement shall survive any decree of divorce which may be entered." And the decree stated "It is ordered that said agreement and said trust agreements forming a part thereof shall survive this decree." The Court of Appeals turned the case on those provisions. It concluded that since there were two sanctions for the payments and transfers—contempt under the divorce decree and execution under the contract—they were founded not only on the decree but upon both the decree and a "promise or agreement." It therefore held the excess of the value of the property which petitioner gave her husband over what he gave her to be taxable as a gift. 178 F.2d 861.

We, however, think that the gift tax statute is concerned with the source of rights, not with the manner in which rights at some distant time may be enforced. Remedies for enforcement will vary from state to state. It is "the transfer" of the property with which the gift tax statute is concerned, not the sanctions which the law supplies to enforce transfers. If "the transfer" of marital rights in property is effected by the parties, it is pursuant to a "promise or agreement" in the meaning of the statute. If "the transfer" is effected by court decree, no "promise or agreement" of the parties is the operative fact. In no realistic sense is a court

decree a "promise or agreement" between the parties to a litigation. If finer, more legalistic lines are to be drawn, Congress must do it.

If, as we hold, the case is free from any "promise or agreement" concerning marital rights in property, it presents no remaining problems of difficulty. The Treasury Regulations [8] recognize as tax free "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from donative intent)." This transaction is not "in the ordinary course of business" in any conventional sense. Few transactions between husband and wife ever would be; and those under the aegis of a divorce court are not. But if two partners on dissolution of the firm entered into a transaction of this character or if chancery did it for them, there would seem to be no doubt that the unscrambling of the business interests would satisfy the spirit of the Regulations. No reason is apparent why husband and wife should be under a heavier handicap absent a statute which brings all marital property settlements under the gift tax. . . .

Reversed.

MR. JUSTICE FRANKFURTER, joined by MR. JUSTICE BLACK, MR. JUSTICE BURTON, and MR. JUSTICE MINTON, dissenting.

Section 503 of the Revenue Act of 1932 imposes a gift tax on property "transferred for less than an adequate and full consideration in money or money's worth." 47 Stat. 247, now I.R.C. § 1002. In *Merrill v. Fahs,* 324 U.S. 308, the Court held that an antenuptial settlement is subject to this tax.[9] Believing as I do that the disposition of the case before us largely depends on the weight given to the considerations which there prevailed, recapit-

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[8] Section 86.8 of Treas.Reg. 108 provides: "Transfers reached by the statute are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration in money or money's worth to the extent that the value of the property transferred by the donor exceeds the value of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. A consideration not reducible to a money value, as love and affection, promises of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift."

[9] The Merrill settlement did not involve release of support rights. Nor are they involved in the case before us, for the transfer here sought to be taxed passed to the husband from the wife, who was under no obligation to support him. We are, therefore, here not concerned with the Commissioner's view that "to the extent that the transfers are made in satisfaction of support rights the transfers are held to be for an adequate and full consideration." E. T. 19, 1946–2 Cum.Bull. 166. See 2 Paul, Federal Estate and Gift Taxation § 16.15. But cf. Meyer's Estate v. Commissioner, 110 F.2d 367; Helvering v. United States Trust Co., 111 F.2d 576.

ulation of them is appropriate. The Court there based its result on the conclusion that a transfer of property pursuant to an antenuptial settlement was not made in exchange for "an adequate and full consideration in money or money's worth." This conclusion was reinforced by reading into the gift tax provision the gloss of the interrelated estate tax of the same year that the relinquishment of "marital rights . . . shall not be considered to any extent a consideration 'in money or money's worth.'" Revenue Act of 1932, § 804, 47 Stat. 280, now I.R.C. § 812(b).

Unless we are now to say that a settlement of property in winding up, as it were, a marriage, smacks more of a business arrangement than an antenuptial agreement and therefore satisfies the requirement of "an adequate and full consideration in money or money's worth" which we found wanting in *Merrill v. Fahs,* and unless we are further to overrule *Merrill v. Fahs* insofar as it joined the gift tax and the estate tax of the Revenue Act of 1932, so as to infuse into the gift tax the explicitness of the estate tax in precluding the surrender of marital rights from being deemed to any extent a consideration "in money or money's worth," we must hold that a settlement of property surrendering marital rights in anticipation of divorce is not made for "an adequate and full consideration in money or money's worth."

. . .

I would affirm the judgment.

Note

This matter is now affected by **sec. 2516** of the 1954 Code, which appears to adopt the rule of the *Harris* case, but which may introduce new complications. For example, to what extent is a transfer incident to a divorce made in settlement of "marital or property rights"? If the wife makes an extremely good deal, will a gift tax be due? [1]

Powers of Appointment

Sec. 2514 of the 1954 Code

The provisions in sec. 2514 of the 1954 Code are parallel to those relating to powers of appointment in sec. 2041 relating to the estate tax. In their present form they go back to the Powers

1 For discussions of the problem prior to the 1954 Code, see Oliver and Buckley, "The Marriage Undone: Taxwise," 42 Calif.L.Rev. 408, 431 (1954); "Divorce and the Estate and Gift Taxes," 36 Minn.L.Rev. 918 (1952); "Post-marital Settlements and the Gift Tax," 19 U. of Chi.L.Rev. 46 (1951); Pedrick, "The Gift Tax Jurisdiction of the Divorce Court," 46 Ill.L.Rev. 177 (1951); Taylor and Schwartz, "Tax Aspects of Marital Property Agreements," 7 Tax L.Rev. 19 (1951); Kaplan, "Are Transfers of Property Pursuant to Separation Agreements Gifts?" 5 Tax L.Rev. 90 (1949); Dicus, "Gift Tax in Relation to Marital Settlements Incident to Divorce," 27 Taxes 1130 (1949); Rudick, "Marriage, Divorce and Taxes," 2 Tax L.Rev. 123 (1947).

of Appointment Act of 1951, which completely rewrote provisions which had been added to the statute in 1942. The provisions of the present statute should be examined.

Note

A will which was drawn and became effective after October 21, 1942, left property to the widow for life, and gave her power (1) to appoint the property among her children by deed during her lifetime, and (2) to appoint the property by will to anyone including her estate. She exercised the power to appoint part of the property to her children. It was held that this constituted a release of the general power to appoint this property by will, and was thus a taxable gift. E.T. 23, 1950–1 Cum.Bull. 133. This ruling would appear to remain applicable under the new statute.

Tenancies by the Entirety

Sec. 2515 of the 1954 Code

The provision in sec. 2515 relating to tenancies by the entirety (and joint tenancies between husband and wife) is entirely new in the 1954 Code. Under the prior law, it was held that a gift was made when a husband bought property and took title in the name of himself and his wife as tenants by the entirety. *Lilly v. Smith,* 96 F.2d 341 (C.C.A.7th, 1938), cert. den. 305 U.S. 604 (1938); *Commissioner v. Hart,* 106 F.2d 269 (C.C.A.3d, 1939).

Note

Why is this provision limited to real property? Would it be desirable to extend it to tenancies by the entirety in personal property, and generally to all joint tenancies?

The Exclusion

Secs. 2503 and 2504 of the 1954 Code

COMMISSIONER v. DISSTON

Supreme Court of the United States, 1945. 325 U.S. 442.

MR. JUSTICE RUTLEDGE delivered the opinion of the Court.

This case, like *Fondren v. Commissioner,* 324 U.S. 18, presents questions whether certain gifts to minors are gifts of "future interests in property," within the meaning of the Revenue Act of 1932, c. 209, 47 Stat. 169.

In 1936 the respondent, William D. Disston, created a trust for the benefit of each of his five children, three of whom were then minors. The total of his gifts that year was $71,952. The Com-

missioner allowed an exemption of $5000 on each gift for the children and on one to his wife. The taxpayer also was allowed the specific exemption of $40,000 provided by § 505 of the Revenue Act of 1932, as amended by § 301(d) of the Revenue Act of 1935. The net gifts for 1936 accordingly were computed to be $1952, upon which a tax was assessed and paid.

In 1937 the taxpayer added to the corpus of the trust securities valued at $25,000, of which $5000 was allocated to each child's interest, including the three who were still minors. In 1938 he created another trust for his five children, the corpus consisting of undeveloped land worth $38,581. Two of the children still were minors.

The two trusts were identical in all respects now material. The principal was divided into five equal shares, one for each child. The trusts were of the spendthrift variety. All shares of the corpus and income were to be free from "anticipation, assignment, pledge, or obligations of beneficiaries," as well as execution or attachment. The shares of the minors alone are now involved. Hence the nature of the trust as applicable to them only need be considered.

The taxpayer's son, William L. Disston, was nineteen in 1936 when the first trust was created. As to his share the trustees were directed, in the Second Article, "to accumulate the net income therefrom for the benefit of William L. Disston until he reaches the age of twenty-one years, at which time to pay over to him all accumulated income, and thereafter to pay over to him in not less than quarterly instalments the entire net income derived therefrom during his lifetime; provided, however, that upon his reaching the age of forty-five years one-half of the principal of his share shall be paid over to him free and discharged of all trusts; and upon further trust upon his death whether before or after reaching the age of forty-five years, to divide the principal of his share, or such portion thereof as is then held by the Trustees, among his then living descendants . . . in such amounts as he shall by will appoint, and in default of such appointment, to divide the same equally per stripes," with provision for division among the taxpayer's other children and their descendants if no descendant of the beneficiary should then be living. The Article contains a proviso that if the taxpayer's son should die before reaching forty-five, the son may appoint to his spouse for a period no longer than her life not more than one-half of the income from his share of the corpus.

Identical provisions were made for the two minor daughters, except that they were to obtain only one-third of the corpus at age forty-five and could appoint to their spouses only one-third of the income.

A subsequent paragraph provided that the trustees should hold the minors' shares during their respective minorities, "and during such time shall apply such income therefrom as may be necessary for the education, comfort and support of the respective minors, and shall accumulate for each minor until he or she reaches the age of twenty-one years, all income not so needed. The foregoing clause shall apply to minor children of the Settlor irrespective of the direction heretofore set forth to accumulate all income for such minors."

In addition the Fourth Article, which defined the trustees' powers, authorizes them "to apply the income to which any beneficiary shall be entitled hereunder for the maintenance, education, and support of such beneficiary should he or she by reason of age, illness, or any other cause in the opinion of the Trustees be incapable of dispensing it. Payment by the Trustees to the parent of any minor . . . shall be sufficient acquittance and discharge to the trustees for such payment or payments."

Finally, the trustees were authorized to invade the corpus in an emergency: "To expend out of the share of principal from which any beneficiary may be receiving income under this deed of trust such sums as Trustees may consider to be for the best interests of such beneficiaries during illness or emergency of any kind; provided, however, that in no case shall such expenditures of principal exceed in the aggregate ten percent (10%) of the value of such share of principal. . . ."

In operation the 1938 trust of unimproved realty had produced no net income to the time the case came before the Tax Court. Most of the 1936 income of the first trust, $288 for each minor, was paid to the mother of the beneficiaries. In 1937 partial payments of income, $94 per minor child, were made. The beneficiaries' mother returned other checks to the corporate trustee in 1937, and one of the individual trustees, an adult child of the taxpayer, directed the corporate trustee thereafter to accumulate the income of the minors. No further payments of income were made to any child prior to his becoming of age.

In determining the taxpayer's gift tax for 1937 the Commissioner disallowed three $5000 exclusions from the net gifts for that year on the ground that the gifts to the three minor children were gifts of future interests. For 1938 the Commissioner disallowed two $5000 exclusions on the ground that the gifts made that year to the two children who were still minors were gifts of future interests.

In computing the gift tax for 1937 and 1938 it was necessary for the Commissioner to compute the aggregate sum of the net gifts for the preceding years. The Commissioner, in determining the net gifts made for this purpose by the 1936 trust, adjusted the

exclusions which he had allowed in 1936 to the extent of $5000 for each of the three minors. The period of limitations for assessment and collection of 1936 gift taxes had run.

The Tax Court upheld the Commissioner, but the Court of Appeals reversed, holding no future interests arose as a result of the gifts to the minors. Consequently it was unnecessary for the Court of Appeals to consider whether the statute of limitations barred readjustment of the net gift figure for 1936 or simply barred collection of any further gift taxes for that year.

The guiding principles were outlined recently in *Fondren v. Commissioner,* 324 U.S. 18. Gifts of "future interests," within the meaning of § 504(b), to any person are not excluded from the computation of net gifts to the extent of the first $5000 in value, as are present interests. Treasury Regulation 79 (1936 ed.), Article 11, defines "future interests" as interests "limited to commence in use, possession, or enjoyment at some future date or time. . . ." The definition has been approved repeatedly. Cf. *Ryerson v. United States,* 312 U.S. 405; *United States v. Pelzer,* 312 U.S. 399; *Fondren v. Commissioner,* 324 U.S. 18.

Clearly the corpus of the trusts falls within the definition. Distribution to William L. Disston, for example, has no relation to his reaching his majority, which he has now attained. He must live to attain the age of forty-five to enable him to receive one-half of the corpus. If he does not reach that age, his estate receives no part of the principal. The recipients are an undetermined group designated in the trust provision, among whom the beneficiary has a limited power of appointment. At the time of the gifts in 1936–1938 it was unknown who in fact would receive this one-half interest. Obviously the enjoyment was postponed.

As to the other half in William L. Disston's share, it likewise was unknown who would enjoy the corpus. One thing only was known, that the named child could not enjoy it. He would continue to receive the income from it for his life, but the principal was not given to him. The possibility that in an emergency the trustees might invade the corpus to the extent of ten per cent for his benefit did not confer a present interest in that part of the principal. The emergency by definition was extraordinary, something that might or might not occur at some indefinite future time. No present, certain and continuous enjoyment was contemplated, nor did it materialize. What has been said of the one minor is true of the others.

The question must be determined whether the trusts provided for a present interest in the trust income, or some definable portion of it. The first direction of each trust is to accumulate the net income until the minor reaches twenty-one. If that were all, it would again be clear that a future interest was created by the

postponement of enjoyment. A later paragraph directs the trustees, however, "to apply . . . such income therefrom as may be necessary for the education, comfort and support of the respective minors" and to accumulate the remainder. . . .

The language of the trust instruments directs that the income be accumulated during minority. The subsequent provision for payments for maintenance and support may be said to indicate a departure from the policy of accumulation only when necessary, in the reasonable discretion of the trustees. If that is the appropriate interpretation of the trust instruments, then little difference from the *Fondren* case is involved. Even in its practical working, the trustees did not find the necessary prerequisites for a steady application of all or any ascertainable part of the income for education, support and maintenance.

But, even though the trustees were under a duty to apply the income for support, irrespective of outside sources of revenue, there is always the question how much, if any, of the income can actually be applied for the permitted purposes. The existence of a duty so to apply the income gives no clue to the amount that will be needed for that purpose, or the requirements for maintenance, education and support that were foreseeable at the time the gifts were made. In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the minor would be required, there is no basis for a conclusion that there is a gift of anything other than for the future. The taxpayer claiming the exclusion must assume the burden of showing that the value of what he claims is other than a future interest. Cf. *New Colonial Co. v. Helvering,* 292 U.S. 435. That burden has not been satisfied in this case.

The question remains whether the adjustment of net gifts for 1936 in computing 1937 and 1938 tax liability is barred by the statute of limitations. As has been noted, § 502 requires utilization of "the aggregate sum of the net gifts for each of the preceding calendar years" in the formula for computing gift tax liability. Section 517(a) does not purport to bar adjustment of the net gift figure for that purpose, but simply prevents assessment and collection of a tax for a year barred by the statute. The statute does not purport to preclude an examination into events of prior years for the purpose of correctly determining gift tax liability for years which are still open. The Tax Court and Treasury Regulations have construed § 517(a) as requiring determination of the true and correct aggregate of net gifts for previous years. The construction is in accord with the statutory language.

Accordingly, the judgment is

Reversed.

Notes

(A) The exclusion in the gift tax was first made applicable to the first $5,000 given to any one person in each year "(other than of future interests in property)." Questions immediately arose under this provision with respect to gifts in trust. Should the number of beneficiaries be counted in determining the number of exclusions, or should the trust be treated as the donee, and one exclusion be allowed for the trust regardless of the number of beneficiaries? While these questions were pending, the parenthetical phrase was amended in 1938 so that it read "(other than of gifts in trust or of future interests in property)." [1] In *Helvering v. Hutchings,* 312 U.S. 393 (1941), the Court held that one exclusion was to be allowed for each present beneficiary. Following this decision, the original form of the parenthetical phrase was restored by the Revenue Act of 1942. These earlier exclusions are incorporated by reference in sec. 2504(b) of the 1954 Code.

At the same time, the Court decided *United States v. Pelzer,* 312 U.S. 399 (1941), and related cases, in which it gave a very broad construction to the words "future interest." The effect of this is shown in the *Disston* case above, and in *Fondren v. Commissioner,* 324 U.S. 18 (1945), which is there discussed.

Should the per donee exclusion be retained, or should there be some sort of annual limit per donor? See "The 'Future Interest' Exception to the Annual Exclusion in Section 2503(b): A Proposed Amendment," 52 Northwestern U.L.Rev. 135 (1957).

(B) Is the gift of a life insurance policy a gift of a future interest in property within the exception to the exclusion provision in section 1003(b)(2)? *Cf. Spyros P. Skouras,* 14 T.C. 523 (1950), aff'd, 188 F.2d 831 (C.A.2d, 1951).

(C) In Rev.Rul. 54–344, 1954–2 Cum.Bull. 319, it was held that a present right to the income of a trust is not a future interest merely because it is subject to spendthrift provisions which prevent the beneficiary from assigning or anticipating the income.

Gifts to Minors

It has long been uncertain whether a gift could be made to a minor which would not be a "future interest," and if such a gift could be made, what was the best form to use in making it. In *Kieckhefer v. Commissioner,* 189 F.2d 118 (C.A.7th, 1951), cert. den. 344 U.S. 836 (1952), a trust was created for a minor, but it contained a provision that his guardian might demand the trust property at any time. It was held that this was sufficient to make it a present interest.[1] See also Rev.Rul. 59–78, 1959–1

[1] At the same time the amount of the exclusion was reduced to $4,000. It was further reduced to $3,000 by the Revenue Act of 1942.

[1] For discussions, see Caritch, "Obtaining the Gift Tax Exclusion on Gifts in Trust," 51 Mich.L.Rev. 621 (1953); "Gifts to Minors as Present Interests," 53 Col.L.Rev. 530 (1953); Diamond, "Tops and Dolls—or Gifts to Minors," 30 Taxes 987 (1952); "Recent Cases Confuse Gift Tax Exclusion," 4 Stanford

Cum.Bull. 690, where it was ruled that power given to a trustee to withhold income did not make a trust for a minor a future interest where the instrument required him to use the property for the benefit of the beneficiary as if held by him as the guardian of the donee.

This matter is now affected by **sec. 2503(c)** of the 1954 Code which is new in that statute.[2] This may resolve the problem for the future, although it is possible that new complications will arise under the new statute.

A number of states have passed "Gift to Minors" Acts. For a discussion of these, see "Gifts to Minors Acts," 36 Taxes 66 (1958).

Note the provision in the last sentence of **sec. 2503(b)**, which is also new in the 1954 Code. Under the earlier law, it was held that the entire gift was a future interest where property was given on trust to pay the income to X for ten years, and then to pay him the principal, with power in the trustee to accelerate the time for paying the principal to X. This was put on the ground that the payment of the principal was obviously a future interest, and the right to the income for a term could not qualify since its value was made indefinite because it might be terminated by a payment of the principal before the end of the ten year period. The new statutory provision should take care of this difficulty in cases where it applies.

L.Rev. 428 (1952); Drexler, "The Exclusion Provision of the Gift Tax Law Needs Amending," 29 Taxes 743 (1951); Rogers, "Some Practical Considerations in Gifts to Minors," 20 Fordham L.Rev. 233 (1951); Rogers, "Outright Gifts to Minors and the Gift Tax Exclusion," 7 Tax L.Rev. 84 (1951); Fleming, "A Different View of Outright Gifts to Minors," 7 Tax L.Rev. 89 (1951).

See also Rogers, "Stifel Stifles Kieckhefer," 7 Tax L.Rev. 500 (1952), dealing with the effect of the decision in Arthur C. Stifel, Jr., 17 T.C. 647 (1951), on the Kieckhefer case.

2 See Rev.Rul. 54–400, 1954–2 Cum.Bull. 319, holding that a gift is not a future interest merely because the donee is a minor. For discussion under the 1954 Code, see Caplin, "How to Treat Gifts to Minors," Proc.N.Y.U. 13th Ann.Inst. on Federal Taxation 193 (1954); Smith, "Tax Aspects of Providing for Minors in Family Property Arrangements," 33 Taxes 909 (1955); Caplin, "Trusts for Minors," 13 Wash. and Lee L.Rev. 145 (1956); Branscomb, "Annual Exclusion Trusts," 37 Taxes 231 (1959).

Deductions

Secs. 2521–2524 of the 1954 Code

Charitable Gifts

Sec. 2522 of the 1954 Code

The deduction for charitable gifts presents questions substantially like those involved in the estate tax. With the discussion, *supra,* p. 931, compare *Otto T. Mallery,* 40 B.T.A. 778 (1939) where the taxpayer and two others created a corporation "for the relief of distress and for the support of worthy needy, indigent, sick or unemployed persons." The three organizers were the board of directors, and the petitioner was president. Among the persons supported by the corporation were "a needy and mentally defective woman who was distantly related to petitioner and whose sister appealed to him for help," his "sister-in-law, whom his brother had deserted in 1916," and "two aged distant relatives whose means were very meager." The gifts to these persons were about one third of the total gifts made by the corporation during the years in question. Are contributions by the taxpayer to this corporation deductible in computing his gift tax liability? [3]

In *duPont v. United States,* 97 F.Supp. 944 (D.Del.1951), it was held that a gift to the "National Economic Council" was not deductible.

Marital Deduction and Split Gifts

Secs. 2523 and 2513 of the 1954 Code

The Revenue Act of 1948 added two new provisions to the gift tax sections of the statute at the same time that the marital deduction was added to the estate tax, and split incomes were introduced to the income tax. These provisions are now found in secs. 2523 and 2513 of the 1954 Code.

The effect of these is to allow a deduction of half the value of the property when the gift is to a spouse and qualifies for the marital deduction [4] (sec. 2523), and to treat a gift by a married person as a gift half by him and half by his spouse, subject to

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3 See "Federal Gift Taxation of Donative Transfers to Family Corporations," 50 Yale L.J. 335 (1940).

4 In Estate of Charles C. Smith, 23 T.C. 367 (1954), a gift was made in 1948 to a life insurance trust of which the donor's wife was a beneficiary. It was held that this did not give the wife any present right to income, and was not a basis for a marital deduction.

the consent of both spouses (sec. 2513). These provisions may be best understood by remembering that the objective was to put taxpayers in the common law states on substantially the same footing as taxpayers in the community property states.

Note that under these provisions, a taxpayer may give his spouse up to $6,000 a year without incurring gift tax liability, since half of the gift is deductible, and the $3,000 annual exclusion will take care of the rest of the gift. Similarly, a taxpayer may give his children (or any one else) up to $6,000 a year without gift tax liability, if his spouse consents, and makes no gifts to the same person. The gift is treated as half by each spouse, and the $3,000 annual exclusion applies to each spouse's half. Likewise, the $30,000 exemption is available to apply against the gifts of each spouse when the annual exclusion is exceeded. However, no part of the exemption of one spouse may be deducted against the gifts of the other spouse. Rev.Rul. 54–30, 1954–1 Cum.Bull. 207.

Valuation, Collection and Computation of the Tax

Valuation

Questions of valuation arise in gift tax cases of substantially the same sort as in estate tax cases. See Rockefeller, "Valuation of Closely Held Stocks for Estate and Gift Tax Purposes," 36 Taxes 259 (1958). For a gift tax case involving the same securities as were involved in *Laird v. Commissioner, supra,* p. 918, see *Du Pont v. Deputy,* 26 F.Supp. 773 (D.Del.1939). Consider this question which was also raised, but not passed upon, in that case (see Findings I and III; 26 F.Supp. at 777). A buys stock for $50. Later, it becomes worth $1,000 on the market, and he gives it to B. Under sec. 1015(a) of the 1954 Code (see p. 612, *supra*), when B sells the stock he will have to use $50 as his basis in computing his taxable gain. In other words he will have to pay much more income tax on such a sale than he would if A had given him property of the same market value, which, however, had cost A $1,000 or more. Is this "inherent" liability for income tax, which reduces the ultimate worth of the gift to B, a relevant factor to take into account in valuing the property for the purpose of computing A's gift tax?

In *Guggenheim v. Rasquin,* 312 U.S. 254 (1941), the taxpayer purchased a paid-up life insurance policy and gave it to her children. She included it on her gift tax return at its cash surrender value, which was considerably less than the cost. The court held that the tax should be based on the cost of the policy. Cf. *Farha Schayek,* 33 T.C. 629 (1960), where a gift was made by transferring property on trust for beneficiaries. It was held that no reduction should be made, in valuing the gift, for the trustee's commission on receiving the property.

Problem and Note

(A) In 1943, T purchased a diamond ring from a retail jeweler. The retail price was $58,000, and the federal excise then payable (and paid) was $5,800, a total of $63,800. T then gave the ring to his wife. He duly filed a gift tax return showing the value of the ring as $58,000. The Commissioner determined that the value of the ring was $63,800, and issued a deficiency letter accordingly. Who prevails? See *Estate of Frank Miller Gould,* 14 T.C. 414 (1950); *Duke v. Commissioner,* 200 F.2d 82 (C.A.2d, 1952), cert. den. 345 U.S. 906 (1953); *Publicker v. Commissioner,* 206 F.2d 250 (C.A.3d, 1953), cert. den. 346 U.S. 924 (1954); Rev.Rul. 55–71, 1955–1 Cum.Bull. 110.

(B) In Rev.Rul. 189, 1953–1 Cum.Bull. 294, it was held that restrictive agreements with respect to donated property are "a factor to be considered with all other pertinent factors of valuation," but "are not binding upon the Commissioner in determining fair market values for Federal gift tax purposes." Compare the material at p. 921(D), above, on the effect of restrictive agreements on estate tax valuations.

Collection of the Tax

The gift tax is payable by the donor (sec. 2502(d) of the 1954 Code), who is required to file a return for each year in which he makes a gift in excess of the exclusion (see sec. 6019(a) of the 1954 Code). This return is now due by April 15th in the year following that in which the gift was made. Sec. 6075(b) of the 1954 Code.

If a return is filed, any additional tax must be assessed within three years after the filing (an early return is regarded as filed on the due date). Sec. 6501 of the 1954 Code. If no return is filed, no limitations period runs. Sec. 6501(c)(3). For this reason it may be advisable in some cases to file returns even though it is believed that no taxable gift has been made. If a return is filed, but there is an omission of 25% or more in stating the amount of the gifts, then the limitation period is six years. Sec. 6501(e).

Liability of donees. If the donor does not pay the tax, then the donee is liable for it since he is a "transferee" of property from the donor. See sec. 6901(a)(1)(A)(iii). The courts have held that the tax may be collected for an additional year against the trustee or donee, under sec. 6901(c)(1). See *e. g., Fidelity Trust Co. v. Commissioner,* 141 F.2d 54 (C.C.A.3d, 1944).[1] Thus the Commissioner always has four years available within which to collect the gift tax.

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[1] An argument for a different view may be found in "The Statute of Limitations in Gift Tax Cases," 57 Harv.L.Rev. 906 (1944).

If the donee is required to pay the gift tax, he may not obtain reimbursement from the estate of the donor. *Fidelity Union Trust Co. v. Anthony,* 13 N.J.Super. 596, 81 A.2d 191 (1951).

Each donee is liable, to the extent of the value of his gift, for the taxes due on any gifts made by the donor during the taxable year, to him or to others. *La Fortune v. Commissioner,* 263 F. 2d 186, 194 (C.A.10th, 1958).

Computation of the Tax

See secs. **2502–2504** of the 1954 Code

The tax is a graduated one with the computation cumulative from year to year. Thus the determination of the tax for this year may involve the consideration of facts relating to many prior years. Even if the statute of limitations has run on a prior year, the amount of gifts made in that year may still be increased for the purpose of putting this year's gifts in a higher bracket.

There is one qualification on this, introduced by the 1954 Code. Under sec. 2504(c) the *value* of a gift made in a prior year cannot be changed if a tax was assessed or paid for that prior year, and the statute of limitations on that year has expired.

Problem

In 1937, A gave $50,000 to his son B, he transferred $100,000 to T upon an irrevocable trust for his wife for life, with remainder to his daughter C, he transferred $60,000 to a revocable trust for his grandchildren, he paid $5,000 as premiums on insurance policies which were irrevocably payable to his son B, and he gave $10,000 to a charity. In 1941, he made exactly similar gifts, and, again, in 1959 he made gifts in the same amounts to the same donees. The insurance premiums were paid annually, but otherwise these were all the gifts which A made since the gift tax became effective in 1932. Compute A's gift tax for 1959.

A number of states now impose their own gift taxes.[1] There is no provision in the federal tax for crediting any of the state tax paid as there is in the case of the estate tax. Should there be? Similarly, there is no provision in the gift tax for a credit or deduction on account of property given on which an estate tax had previously been paid within ten years, as there is in the estate tax. Cf. p. 953, above. Is this a proper distinction?

[1] See Brandis, "State Gift Taxes—Their Relation to Death Taxes," 19 N.C.L.Rev. 304 (1941); "State Gift Taxes: Prospective Problems of Administration," 51 Harv.L.Rev. 533 (1938); Cahn, "State Gift Tax Jurisdiction," 87 U. of Pa.L.Rev. 390 (1939).

In the foreign field, there is one treaty designed to minimize double taxation. See Kauter, "Gift Tax Convention with Australia," 32 Taxes 65 (1954).

Interrelation of Estate and Gift Taxes. Is there any way in which the estate and gift taxes could be combined? Should the estate tax be regarded as simply the final installment of a single transfer tax, with the estate tax rates to be fixed according to the amount of inter vivos gifts which the decedent had made? [2] Should there be a separate exemption for each tax, as now? A Subcommittee of the Committee on Ways and Means in 1938 recommended that only a single exemption be allowed for the two taxes. A provision to this effect was adopted by the House, but it died in Conference. See House Report No. 2330, 75th Congress, 3d Session (1938) 49 (Amendment No. 167).

Problem

T is 52 years old. He has been married for one year to a woman of 30, and has no children. His property consists of a controlling stock interest worth $600,000 in X Company, real estate worth $200,000, and readily marketable stocks and bonds worth $150,000. A "tax expert" advises T that he can save a large amount in estate tax by giving the stocks and bonds to his wife. T asks your advice as a lawyer. Give it. See Boye, "Advantages and Disadvantages of Making Gifts," 13 Tax Mag. 699 (1935).

Consider, among others, the following points:

1. How far should a lawyer's advice be confined to "law"?

2. To make a gift is to make a gift; in other words T must give up all control over the property. How far is that desirable? What are the conceivable consequences?

3. The gift tax must be paid now, the estate tax not until death—at which time there may be no estate tax if the property has declined in value; or estate tax rates may then be lower; or he may eventually want to give the property to charity.

4. T may live a long time, and circumstances may change greatly. He may have many children or none; their needs may vary greatly.

5. T may outlive his wife, in which case he might have to pay an estate tax in order to get back the property on which he had already paid a gift tax. How much would be saved then?

6. What is the effect of the marital deduction provisions in the gift tax and in the estate tax?

7. Are there any alternatives?

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[2] See DeWind, "The Approaching Crisis in Federal Estate and Gift Taxation," 38 Calif.L.Rev. 79 (1950); Rudick, "What Alternative to the Estate and Gift Taxes?" 38 Calif.L.Rev. 150 (1950); Rudick, "A Proposal for an Accessions Tax," 1 Tax L.Rev. 25 (1945); Eisenstein, "Are We Ready for Estate and Gift Tax Revision?" 23 Taxes 316 (1945); Vickrey, "An Integrated Successions Tax," 22 Taxes 368 (1944).

OTHER MATTERS

CHAPTER 13

MISCELLANEOUS TAXES

Sections 4001 through 5862 of the 1954 Code impose a very wide variety of "Miscellaneous Taxes." [1] Some of these are of great importance in the revenue system. The taxes on tobacco, imposed now by sections 5701–5763 of the 1954 Revenue Code produced $1,806,816,000 in revenue in the fiscal year 1959.[2] The liquor taxes (sections 5001–5693 of the 1954 Code) amounted to $3,002,096,000 in the same period. Report of the Commissioner of Internal Revenue for 1959, p. 3. These taxes are collected from a few taxpayers, at small expense, and virtually without litigation. Many of the miscellaneous taxes are obviously designed to do something other than produce revenue. See for example the taxes on the circulation of bank notes in sections 4881–4886, on narcotics, white phosphorous matches, filled cheese, and on firearms, imposed by sections 4701–4776, 4801–4806, 4831–4846, 5801–5831 of the 1954 Code.

Extensive amendments were made to many of the excise tax provisions in 1958, by the Excise Tax Technical Changes Act of 1958, Act of Sept. 2, 1958, c. 85–859, 72 Stat. 1275.

The long standing federal taxes on the manufacture and sale of oleomargarine were repealed by the Act of March 16, 1950.

Some of the remaining taxes present problems which may be of concern in general tax practice. These are presented in this Chapter.

In 1951, Congress imposed a tax on wagering, now found in secs. 4401–4423 of the 1954 Code. These provisions impose a tax of 10% on the amount of wagers as defined in the Act. They also impose a special occupational tax of $50 a year on any person who is engaged in receiving wagers. The constitutional validity of this tax was upheld in *United States v. Kahriger,* 345 U.S. 22

[1] See Due, "Federal Excise Taxation," 33 Bull.Nat.Tax Assn. 66 (1947); Schafer, "Federal Excise Taxes," 28 Taxes 299 (1950).

[2] See Law, "Tobacco Taxation in the Revenue System," 6 Nat.Tax J. 372 (1953).

(1953), set out at p. 61, above. The tax has not been notably successful from any point of view. The amount of revenue collected under it in 1959 was $6,221,000.

Problem

Are these provisions enforceable? Are they desirable in a general taxing statute? If not, how can they be differentiated from the taxes now imposed on narcotics, certain firearms, and other articles, where the chief purpose of the tax is to suppress traffic in the articles? Are these taxing provisions likely to be successful in suppressing wagering of the sort to which they apply? Is it reasonable to differentiate between various types of gambling, subjecting some to a prohibitive tax while leaving others untaxed?

A criminal conviction for conspiring to avoid this tax was sustained in *Leahy v. United States,* 272 F.2d 487 (C.A.9th, 1959).

A. GENERAL

UNITED STATES v. HUDSON

Supreme Court of the United States, 1937. 299 U.S. 498.

MR. JUSTICE VAN DEVANTER delivered the opinion of the Court.

Respondent bought on May 3, and sold on May 23 and 29, all in 1934, certain futures contracts for the delivery of 500,000 ounces of silver, and realized therefrom, after deducting allowed expenses, a profit of $8,621.96. He paid a tax of 50 per cent. of this profit in obedience to the taxing provision of the Silver Purchase Act of June 19, 1934,[1] duly but unsuccessfully sought to have the amount of the tax refunded, and then brought suit in the Court of Claims to recover the same. The court held the tax invalid, as retroactively applied to respondent's sales, and gave judgment accordingly. 12 F.Supp. 620; 13 F.Supp. 640. The case is here on certiorari.

The Silver Purchase Act, in section 8, imposes on all transfers of any interest in silver bullion, where the price for which such interest is transferred exceeds the total cost and allowed expenses, a tax of 50 per centum of such excess, and requires that the tax be paid by affixing to a memorandum of the sale lawful stamps in the amount of the tax. The section further provides that the tax, besides reaching transfers thereafter made, shall be applicable to transfers made on or after May 15, 1934, and prior to the date of the act, with the qualification that as to such prior transfers the tax shall be paid in such manner and at such time as the Commissioner, with the approval of the Secretary of the Treasury, may by regulation prescribe.

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1 Chapter 674, sec. 8, 48 Stat. 1178.

The question presented for decision is whether, in view of the restraints of the due process of law clause of the Constitution,[2] the retroactive provision under which the tax was exacted from the respondent is an admissible exertion of the power to tax.

Examination of the taxing provision and of pertinent decisions shows, as we think, that the answer must be in the affirmative.

The taxing provision does not impose a tax in respect of all transfers, but only in respect of such as yield a profit over cost and allowed expenses. If there be no profit, there is to be no tax. If there be a profit, the tax is to be 50 per cent. of it. Thus a profit is made the occasion for the tax and also the measure of it. Because of this, counsel for the government contend that the tax is a special income tax; and we think the contention is sound.

It is not material that such profit is taxed, along with other gains, under the general income tax law, for Congress has power to impose an increased or additional tax if satisfied there is need therefor. *Patton v. Brady,* 184 U.S. 608, 620–622.

As respects income tax statutes, it long has been the practice of Congress to make them retroactive for relatively short periods so as to include profits from transactions consummated while the statute was in process of enactment, or within so much of the calendar year as preceded the enactment; and repeated decisions of this Court have recognized this practice and sustained it as consistent with the due process of law clause of the Constitution. *Stockdale v. Insurance Company,* 20 Wall. 323, 331, 332, 341; *Brushaber v. Union Pacific R. Co.,* 240 U.S. 1, 20; *Lynch v. Hornby,* 247 U.S. 339, 343; *Cooper v. United States,* 280 U.S. 409, 411. And see *Milliken v. United States,* 283 U.S. 15, 21. The cases on which the Court of Claims partly rested its decision were both examined and distinguished in *Cooper v. United States* and *Milliken v. United States.*

The period of retroactivity prescribed for this taxing provision reaches backward from June 19, 1934, the date of the act, to and including May 15, 1934—35 days. For some months prior to this period there was strong pressure for legislation requiring increased acquisition and use of silver by the government, and several bills providing therefor were presented in the Senate and House of Representatives. On May 22 the President sent to Congress a message[3] recommending legislation for increasing the amount of silver in our monetary stocks and further recommending the imposition of a tax of at least 50 per cent. on profits accruing from private dealing in silver. The bill which became the Silver Purchase Act was introduced May 23 in response to

[2] The Fifth Amendment contains the due process of law clause applicable to the United States.

[3] Hearings on H.R. 9745, Silver Purchase Act of 1934, pp. 1 and 2.

this message. In these circumstances, we think the period of retroactivity fixed in the act is not unreasonable, but consistent with the practice sustained by this Court in the cases already cited.

It results that the Court of Claims erred in holding the retroactive provision invalid as applied to respondent's sales.

Judgment reversed.

Problems

(A) How does this case compare with such decisions as *Nichols v. Coolidge, supra*, p. 841, and *Untermyer v. Anderson, supra*, pp. 964–965.

(B) The taxpayer bought a quantity of silver, and then sold it in several lots, part at a profit, and part at a loss. Is the tax to be computed on the net profit, or on the total profits from the profitable sales without any deduction for the losses from the other sales? *Manufacturers Trust Co. v. United States*, 91 Ct.Cl. 406, 32 F.Supp. 289 (1940), cert. den. 312 U.S. 691 (1941).

(C) After considerable vacillation, the Treasury finally ruled that the silver tax was deductible in computing income tax. Mim. 4587, 1937–1 Cum.Bull. 74.

McCAUGHN v. HERSHEY CHOCOLATE CO.

Supreme Court of the United States, 1931. 283 U.S. 488.

MR. JUSTICE STONE delivered the opinion of the Court.

Section 900 of the Revenue Act of 1918, 40 Stat. 1057, 1122, imposed, at varying percentages, an excise tax upon the sales price of enumerated articles, most of which may be characterized as luxuries. The enumeration of the ninth subdivision was, "Candy, 5 per centum." Section 900(6) of the Revenue Act of 1921, 42 Stat. 227, 292, re-enacted this provision but reduced the tax to 3 per cent. Respondents, manufacturers of "sweet chocolate" and "sweet milk chocolate," brought suits in the District Court for Eastern Pennsylvania, to recover about $8,000,000 of taxes assessed under these sections for the years 1918 to 1924, on the ground that the articles sold are not "candy," sale of which was taxed. On written stipulation of the parties, the cases were tried by the court without a jury. Judgments for petitioners were reversed by the Court of Appeals for the Third Circuit. 42 F.2d 408. This Court granted certiorari, 282 U.S. 827, to resolve the conflict of the decision below with that of the Court of Appeals for the First Circuit, in *Malley v. Walter Baker & Co.*, 281 F. 41.

The trial court found that sweet chocolate is a solid or plastic mass, made by mixing sugar with chocloate, which is the powdered cacao nib or bean, with or without the addition of flavor-

ing material, and that sweet milk chocolate also contains milk solids; that the type of sweet chocolate manufactured and sold by respondents is commonly sold in small bars, sometimes containing nuts, or in blocks, "attractively dressed up" for sale under names which would appeal to candy consumers, and is usually consumed in the same manner as candy, that is, eaten in small quantities from the hand as a sweetmeat. One of the respondents described its product as a "confection" upon some of its labels and display matter.

Respondents rest their case mainly upon differences in composition of sweet chocolate from that of confectionery, made principally of sugar or molasses, with or without the addition of coloring or flavoring matter, which, it is urged, is alone described by the word "candy." They assert that chocolate is food and candy is not, and hence chocolate cannot be properly described as candy. But it is common knowledge that sugar, also a food, is an ingredient both of candy as thus defined and of sweet chocolate, sometimes to the extent of 50 per cent. or more of the latter, as was conceded on the argument here. We likewise know, as was conceded, that chocolate in a great variety of forms is an important ingredient of what is commonly known as candy, and that pieces of sweet chocolate of the type described by the findings are often included in packages of confectionery commonly sold as candy. These considerations at least suggest that the form and use of sugar compounds, intended for taste gratifying consumption, are quite as important in determining whether they are candy, as their particular composition. See *Malley v. Walter Baker & Co., supra,* page 46.

No doubt the word "candy," in view of its use to designate confections made principally of sugar before the widespread consumption of sweet chocolate preparations as confections or sweetmeats, and as the dictionary suggests, may be used in this narrower and more restricted sense. But it may be, and we think is used as the dictionary also suggests, in a popular and more general sense, as synonymous with sugar compounds sold and used as confectionery or sweetmeats, and embraces them, as well as candy made chiefly of sugar.

If it were necessary to our decision, in the absence of any controlling legislative history or any suggested plausible reason why a tax on candy, in a general revenue measure taxing luxuries, should be deemed to apply to one type of confectionery and not the other, we should hesitate to say that the word was used in its restricted sense, or to hold that a substance made of sugar and chocolate, a widely known and popular form of confectionery identified, in use and method of distribution, with other types of confectionery known as "candy," was not intended to be taxed.

See *DeGanay v. Lederer*, 250 U.S. 376, 381; *Van Camp & Sons v. American Can Co.,* 278 U.S. 245, 253.

Possible doubts as to the proper construction of the language used should be resolved in the light of its administrative and legislative history. Shortly after the adoption of the 1918 Act, Art. 22 of Regulations 47, May 1, 1919, announced that "Candy within the meaning of the act includes . . . sweet chocolate and sweet milk chocolate, whether plain or mixed with fruit or nuts." This continued to be the ruling of the Treasury Department until the repeal of the tax by section 1100(a) of the Revenue Act of 1924, 43 Stat. 253, 352. It and later regulations excluded unsweetened chocolate from the tax and, as revised in December, 1920, the regulation, and also article 19 of Regulations 47, January 6, 1922, under the 1921 Act, excluded from the tax all sweet chocolate which obviously would not be consumed in the condition or form in which sold. This was but a recognition that use may be a determining factor in ascertaining what sugar compounds are embraced in the word candy.

The administrative construction was upheld in 1922 by *Malley v. Walter Baker & Co., supra,* the only case, other than the present, which has considered it. The provision has been consistently enforced as construed, was re-enacted by Congress in the 1921 Act, and remained on the statute books without amendment until its repeal. Such a construction of a doubtful or ambiguous statute by officials charged with its administration will not be judicially disturbed except for reasons of weight, which this record does not present. See *Brewster v. Gage,* 280 U.S. 327, 336; *Universal Battery Co. v. United States,* 281 U.S. 580, 583; *Fawcus Machine Co. v. United States,* 282 U.S. 375, 378. The reënactment of the statute by Congress, as well as the failure to amend it in the face of the consistent administrative construction, is at least persuasive of a legislative recognition and approval of the statute as construed. See *National Lead Co. v. United States,* 252 U.S. 140, 146. We see no reason for rejecting that construction.

The court below found support for its decision in the fact that various tariff and revenue acts have separately classified candy and chocolate, and respondents make the point here. But it is to be noted that in none of the acts cited does the word candy appear alone, as in the present statute. In the earlier tariff acts the duty was laid on "sugar candy." See Act of August 10, 1790, 1 Stat. 180; Act of June 7, 1794, 1 Stat. 390. In those of August 5, 1909, 36 Stat. 11; October 3, 1913, 38 Stat. 114; and September 21, 1922, 42 Stat. 858, which may be taken as typical, a duty was imposed on importations of "sugar candy and all confectionery not specially provided for" at one rate and by a different paragraph, on chocolate, at a different rate. The differences in rate

made classification necessary; and as the cacao bean is not produced in the United States and sugar is, that fact may be taken to account in a tariff act for the differences both in rate and classification. But a difference in composition, relatively minor so far as it has any bearing on the general character of the product or its use, is of little moment in determining whether the product falls within or without a single class of luxuries taxed, for revenue only, at a single rate. Similarly, rulings of the Department of Agriculture setting up standards under the Pure Food Laws for the composition of various types of confectionery including sweet chocolate, throw no light on the present problem.

Nor do we think of significance the fact relied upon here and by the court below that statements inconsistent with the conclusion which we reach were made to committees of Congress or in discussions on the floor of the Senate by senators who were not in charge of the bill. For reasons which need not be restated, such individual expressions are without weight in the interpretation of a statute. See *Duplex Co. v. Deering,* 254 U.S. 443, 474; *Lapina v. Williams,* 232 U.S. 78, 90; *United States v. Trans-Missouri Freight Ass'n,* 166 U.S. 290, 318.

Reversed.

Notes and Problems

(A) The tax involved in the *Hershey Chocolate* case is now repealed, but the same sort of line-drawing question is still presented in the application of the several manufacturer's excise taxes which still remain. *Cf. White v. Aronson,* 302 U.S. 16 (1937), where jig-saw puzzles were held not to be "games" within the tax imposed by section 609 of the Revenue Act of 1932.

(B) What is a "social club" within section 4241 of the 1954 Revenue Code? The Cosmos Club of Washington (*Cosmos Club v. United States,* 70 Ct.Cl. 366, 42 F.2d 321 (1930)), the Merchants Club of New York (*Merchants Club v. United States,* 106 Ct.Cl. 562, 106 F.Supp. 562 (1946)), and the Men's Faculty Club of Columbia University (*Tidwell v. Anderson,* 72 F.2d 684 (C.C.A.2d, 1934)), have all been held not taxable; while the Century Association of New York (*Century Association v. Anderson,* 10 F.Supp. 1005 (S.D.N.Y.1935)), the Traffic Club of Chicago (*Lavidge v. United States,* 141 Ct.Cls. 634, 159 F.Supp. 376 (1958)), the Faculty Club of the University of California (*Faculty Club v. United States,* 65 Ct.Cl. 754 (1928)), the Bankers Club of New York (*Bankers Club v. United States,* 115 Ct.Cls. 50, 87 F.Supp. 253 (1949)), and the Engineers Club of Dallas (*Engineers Club of Dallas v. United States,* 251 F.2d 52 (C.A.5th, 1958)), have been held "social" and taxable. How is this line drawn? What are some of the factors which bear on the question? See Ray and Hammonds, "The Luncheon Club and the Federal Excise Tax," 28 Taxes 321 (1950).

(C) A country club charged dues of $100 a year. It maintained a golf course, and any member, by paying $50 a year additional, could have a golf privilege. Is the $50 payment subject to tax? See *White v. Winchester Country Club,* 315 U.S. 32 (1942).

H. R. LABORATORIES, INC. v. UNITED STATES

United States Circuit Court of Appeals, Second Circuit, 1945. 151 F.2d 118.

CHASE, CIRCUIT JUDGE. When the excise tax on sales of toilet preparations by manufacturers took effect on June 21, 1932, Helena Rubinstein, Inc., a New York corporation, became taxable on its sales of them by virtue of § 603 of the Revenue Act of 1932. For a short time it added the amount of the taxes to its invoices but then decided to eliminate that practice and reimbursed its customers for the taxes thus passed on by delivering to them additional goods whose price equaled the taxes for which they had been charged.

But in August 1932, the corporation attempted to minimize this tax burden. The plaintiff was organized under the laws of New York and Helena Rubinstein, Inc., transferred to it, in exchange for all its capital stock, the manufacturing part of the business of the parent corporation. From September 1, 1932, throughout the period involved in this suit the plaintiff manufactured and sold to the parent corporation and to two wholly owned subsidiaries of the latter, Helena Rubinstein, Inc., of Washington and Helena Rubinstein, Inc., of California, products whose sales were taxable under the above statute. These sales were made at prices lower than those which the parent corporation had formerly charged to the trade, and the excise taxes on those sales were computed and paid by the plaintiff on such lower prices.

The Commissioner, acting under the provisions of § 619(b) (3) of the 1932 Act, determined that those sales by the plaintiff were at less than the fair market price and were not made through an arm's-length transaction. Accordingly, he assessed additional taxes computed on prices which he determined to be the prices for which such articles were sold in the ordinary course of business by the manufacturers or producers thereof. The plaintiff paid those additional taxes. A partial rebate was allowed, but the plaintiff filed four timely claims for refund which together covered the period from January 1, 1934, to June 30, 1939, and which were rejected in full. Thereafter this suit was brought to recover with interest from defendant Higgins, Collector of Internal Revenue for the Third District of New York, the sum of $115,203.82 and from the United States $413,238.55 which had been paid to another collector who thereafter died.

The plaintiff originally contended both that the Commissioner lacked a proper basis for invoking § 619(b) for the assessment of additional taxes and that, even if the taxes were assessable under that section, not all the exclusions which should have been made under § 619(a) had been given effect in establishing the price base for the computation of the taxes. Among those items

were expenses which it claimed should have been excluded by virtue of the phrase "or other charge" in the statute but which were held in *F. W. Fitch Company v. United States,* 323 U.S. 582, 65 S.Ct. 409, not to be excludible. The plaintiff then reduced its claim accordingly and sought to recover the remainder of $255,-347.33 plus interest at the trial below, which was by the court without a jury. After finding the facts the court concluded that no cause of action had been proved and dismissed the complaint on the merits. This appeal is from that judgment. . . .

The appellant does not now contend that sales of its products to its parent and the latter's two subsidiaries were made either at the fair market price or through arm's-length transactions. In other words, it concedes that the Commissioner properly invoked the provisions of § 619(b) in making the additional assessments but claims that in so doing he acted arbitrarily and failed to exclude certain items of expense which § 619(a) requires to be excluded in determining the price tax base under § 619(b).

The section last mentioned reads as follows in so far as now pertinent:

"(b) If an article is * * * (3) sold (otherwise than through an arm's length transaction) at less than the fair market price; the tax under this title shall (if based on the price for which the article is sold) be computed on the price for which such articles are sold, in the ordinary course of trade, by manufacturers or producers thereof, as determined by the Commissioner."

Art. 15 of T.R. 46 (1932 Ed.) provided in part that:

"Where, for any reason, a manufacturer's sale price does not properly reflect the price for which similar articles are sold at the price of manufacture or production in the ordinary course of trade by manufacturers and the sale is not an arm's-length transaction, the tax shall be computed upon a fair market price."

Purporting to act under the above quoted statute and regulation, the Commissioner consulted manufacturers of like products as well as the Toilet Goods Association, and also held a hearing in Washington. He determined that it was the practice in the trade for manufacturers of such products to allow trade discounts of 33⅓% from the indicated retail prices of the articles and then an additional jobber's discount of 16⅔%. As these two discounts together were the equivalent of one discount of 44.5% from the suggested retail price, he determined that 55.5% of that retail price was the price at which such articles are sold by the manufacturers or producers thereof, in the ordinary course of trade. That is called in this record the 55.5 formula and it was applied in assessing the plaintiff's additional taxes.

Though the average discount of the Rubinstein group on outside sales did not include any discount to jobbers, since it made

no sales to them, and was 37% off suggested retail prices, the Commissioner gave the plaintiff the benefit of the 44.5% discount which obtained generally in the trade, and, as the trial court found on adequate evidence, made the deficiency assessments in the following way:

"(1) From the sales as reflected by the books he excluded non-taxable sales and the established taxable sales he reduced by certain statutory deductions but did not make any deduction for selling, advertising and general or administrative selling expense as such.

"(2) After determining that the plaintiff's established wholesale price was 63%, or thereabouts, of its suggested retail price, he revalued the net adjusted taxable wholesale sales figures to 100% to ascertain the retail sales value of same.

"(3) From the retail sales value thus ascertained he deducted 44½%, representing discounts of 33⅓% as average trade discount and 16⅔% as average jobber's discount, thereby establishing the wholesale fair market value of the sales, namely at 55.5% of the suggested retail value of the taxable sales.

"(4) He computed the tax by applying the statutory rates of 10% and 5%."

The appellant, now represented by counsel retained since the trial below, insists that the Commissioner erroneously failed to reduce the price base by what it calls certain mandatory statutory exclusions, deductions and adjustments which it designates as part of the amount of excise tax imposed by the Act from August 1938 to June 30, 1939, transportation charges, delivery charges, bona fide cash discounts, rebates, and some allowances. The appellees dispute appellant's right to raise those issues here because they were not put in issue by the refund claims or litigated in the court below. Perhaps they might be disposed of on that technical ground, but we prefer to deal with them otherwise as they raise an important question relating to the administration of this tax and we think the appellant has misconceived its rights as a taxpayer liable for the taxes assessable on the price base determined under § 619(b).

The scheme of the statute is to have the taxes ordinarily determined upon the price base established by the taxpayer itself whenever that price base reflects the fair market price of the articles. Then the adjustments required by § 619(a) are indeed mandatory and must be made as the statute and regulations provide. When, however, the taxpayer's own sales prices are less than the fair market price of the goods sold and are not the result of arm's-length transactions, the Commissioner must use another price base for computing the tax and that is "the price for which such articles are sold in the ordinary course of trade, by manufacturers or producers thereof, as determined by the

Commissioner." § 619(b). The statute does not undertake to prescribe how the Commissioner shall make that determination or what factors shall be given consideration in determining the particular manufacturing expenses of the taxpayer. When a taxpayer makes it impossible for the Commissioner to assess the taxes in accordance with § 619(a), they become assessable not on the taxpayer's own adjusted price base but on that of the trade in general; and if the two coincide it is only by happenstance. To be sure, the Commissioner must determine the price base under § 619(b)(3) fairly and with due consideration given to all things required to enable him to arrive at a just determination. But unless it appears that he has not done so a taxpayer cannot complain that exclusions which § 619(a) would have required to be made, had the sales been at fair prices, were not specifically made.

The cosmetic industry presented the Commissioner with difficult tax problems when it began to make inter-group changes in its selling practices after this excise tax took effect. We have previously had occasion to consider some of them. See, *Bourjois, Inc., v. McGowan,* 2 Cir., 85 F.2d 510, certiorari denied 300 U.S. 682; *Concentrate Mfg. Corporation v. Higgins,* 2 Cir., 90 F.2d 439, certiorari denied 302 U.S. 714; *L. T. Piver, Inc. v. Hoey,* 2 Cir., 101 F.2d 68. He properly made use of the first sales outside the group as a factor in determining the price base for taxation. *Bourjous, Inc., v. McGowan, supra.* He appears to have adopted a fair and reasonable method for adjusting those prices by means of a formula reflecting the general practice in the trade to arrive at the price base of § 619(b). The trial judge found that the price as determined by the Commissioner was a fair market price within the meaning of § 619(b), and we think the record on this appeal bears him out. . . .

Judgment affirmed.

Note

The corresponding provision in the 1954 Code is sec. 4216(b), which was amended by the Excise Tax Technical Changes Act of 1958.

POLAROID CORPORATION v. UNITED STATES

United States Court of Appeals, First Circuit, 1956. 235 F.2d 276.

HARTIGAN, CIRCUIT JUDGE. This is an appeal from a judgment entered February 28, 1956, in the United States District Court for the District of Massachusetts dismissing the complaint following a trial without jury upon the merits.

The action was brought under 28 U.S.C. §§ 1340 and 1346 to recover an excise tax of $4.24 paid by Polaroid Corporation, a

Delaware corporation having its principal place of business in Massachusetts, upon the sale of a camera, pursuant to § 3406(a) (4) of the Internal Revenue Code of 1939,[1] which provides in part:

"§ 3406. *Excise taxes imposed by the Revenue Act of 1941*

"(a) *Imposition.* There shall be imposed on the following articles, sold by the manufacturer, producer, or importer, a tax equivalent to the rate, on the price for which sold, set forth in the following paragraphs (including in each case parts or accessories of such articles sold on or in connection therewith, or with the sale thereof):

* * * * * * * * *

"(4) *Photographic apparatus.* Cameras * * *, 10 per centum. * * *"

This is a test case to determine whether the incidence of this tax is upon Polaroid or upon Greist Manufacturing Company, a Connecticut corporation having its principal place of business in Connecticut, which was permitted by the judge below to intervene.

The facts are undisputed. The Polaroid Highlander Camera was invented by the president of Polaroid, Dr. Edwin H. Land. Polaroid owns product patents on the camera and certain of the component parts, but has no patent covering any process or operation involved in making the camera.

Greist fabricates the camera pursuant to a contract purporting to be a sales agreement under which Greist agreed to sell and deliver to Polaroid, at a fixed price per delivered camera, 100,000 cameras to be produced by Greist in accordance with approved specifications.

Greist worked out all production techniques and independently of Polaroid established the unit price of the cameras.

All manufacturing operations involved in the production of the cameras are performed by Greist or its subcontractors. All materials and parts are purchased or produced by Greist. All labor and supervisory personnel are supplied by Greist. Polaroid advances no money or credit. The cameras are delivered by Greist in a finished and packaged condition. Polaroid furnishes only printed matter to be inserted in the package.

Greist has complete control of all manufacturing methods and production, subject only to Polaroid's right to make tests to determine whether the cameras meet specified standards.

All standard production tools are owned by Greist. Specialized tools are designed by Greist and purchased or fabricated at

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1 The corresponding provision of the 1954 Code is sec. 4171. Ed.

its own expense, but the contract provides that Polaroid shall purchase these tools over a period of time from Greist at cost.

Greist maintains a supply of finished cameras from which shipments are made pursuant to Polaroid's instructions either to Polaroid in Cambridge or directly to Polaroid's consignees.

The Polaroid trademark is affixed to the camera by Greist. Title to all cameras remains in Greist until they are segregated following Polaroid's approval of the six sample cameras taken from each day's production. Greist guarantees the camera and component parts against defects.

The contract contains an escalator clause providing for changes in the unit price of the camera to reflect changes of 10¢ or more in Greist's manufacturing costs resulting from general changes in base wage rates or the competitive market price of materials.

In his opinion the trial judge said:

"* * * Polaroid not only agrees to buy Greist's entire output, but it dictates the amount of that output. If Polaroid's orders do not use up Greist's capacity, Greist is not free to sell elsewhere. If various costs go up, the risk is Polaroid's. If Greist manages to cut them, the gain is Polaroid's. The specialized tools are Polaroid's. The product patents, without which Greist could not operate, are retained by Polaroid, except for an implied license, for Polaroid's own benefit. Polaroid may terminate without cause, and Greist can never make another camera. In many important ways, therefore, Polaroid retains the dominant hand.

"The patents seem to me of particular significance. If Greist were the ordinary uncontrolled manufacturer it would have to pay royalties to Polaroid, which, in turn, would be reflected in the sales price upon which the tax would be computed. Plaintiff's counsel made it plain in his opening that it was his contention, and would be Greist's, for whose tax, if any, the contract made Polaroid responsible, that the tax should be Greist's on the basis of Greist's cash price to Polaroid. This disregards the fact that Polaroid was supplying a necessary and valuable component of any sale, a license under the patents. This absence of royalties is an abnormal situation. I think Polaroid is trying to eat its cake and have it."

The trial judge went on to say:

"* * * Obviously there is bound to be a difficult border line as to when, in the concept of this act, one is a manufacturer or only a buyer. The case at bar may be close. It is my opinion, however, that the balance favors the government. * * *"

We agree that Polaroid is the manufacturer of the camera within the meaning of the statute for the reasons just quoted.

We believe further that the sale, so-called, of the cameras by Greist to Polaroid does not represent a "first sale" of the product under the rule of *Indian Motocycle Co. v. United States*, 1931, 283 U.S. 570, 574, where the Court said:

"* * * It is not laid on all sales, but only on first or initial sales—those by the manufacturer, producer or importer. Subsequent sales, as where purchasers at first sales resell, are not taxed. Counsel for the government base their contention on the requirement that the tax be paid by 'the manufacturer, producer or importer'; but we think this requirement is intended to be no more than a comprehensive and convenient mode of reaching all first or initial sales * * *."

Even assuming that the relationship between the parties was that of buyer and seller rather than principal and agent, the "sale" of these cameras transferred to Polaroid only the bare right to possession of the physical materials. Greist did not transfer to Polaroid the right to use these cameras or the right to resell them, since it could convey no more than it had of the various incidents of ownership. It is true, of course, that Polaroid could use or resell the cameras but this was made possible only by rights previously vested in Polaroid and *not by virtue of any property rights conveyed to it by Greist.*

We believe that a "sale" which conveys no right to use or resell the product, but only a bare right to possession, is not a sale within the meaning of § 3406(a)(4).

The judgment of the district court is affirmed.

WOODBURY, CIRCUIT JUDGE (dissenting). This is indeed a close case. Nevertheless the fact remains that Polaroid fabricated no part of the completed cameras, nor is there any basis for saying that the cameras were made by Greist either as Polaroid's agent, or as Polaroid's alter ego. Greist did not manufacture only Polaroid's cameras but in addition manufactured a variety of mechanical "precision assemblies," principally for sewing machines, for other purchasers. Neither were the cameras fabricated by Greist from any parts or materials furnished by Polaroid to which it retained title which would bring this case within the provisions of subsection (b) of Treasury Regulations 46 (1940) § 316.4 which in its entirety reads:

"Who is a manufacturer—(a) The term 'manufacturer' includes a person who produces a taxable article from scrap, salvage, or junk material, as well as from new or raw material, (1) by processing, manipulating, or changing the form of an article, or (2) by combining or assembling two or more articles.

"(b) Under certain circumstances, as where a person manufactures or produces a taxable article for a person who furnishes materials and retains title thereto, the person for whom the

taxable article is manufactured or produced, and not the person who actually manufactures or produces it, will be considered the manufacturer."

Polaroid and Greist are wholly separate and distinct entities who struck an arm's length bargain whereby Greist as an independent contractor "manufactured" the cameras in the sense of making them, fabricating them, putting them together, with its own employees out of its own materials, and parts it purchased from third parties, and then sold them for an agreed price to Polaroid. The fact that because of Polaroid's patents Greist had and legally could have only one customer for the cameras and the fact that the cameras were made according to Polaroid's specifications and subject to its inspection seem to me beside the point. Certainly if Greist in violation of the patent law and its contract with Polaroid sold a camera or cameras to some one other than Polaroid it would be liable for the tax on those cameras.

It seems to me that in ordinary language Greist was the manufacturer and Polaroid a purchaser who sold the cameras at wholesale. Thus to impose the tax on Polaroid is to base the tax not on the manufacturer's sale price in accordance with the statute but on the wholesaler's sale price, which naturally is greater since it includes, presumably, in addition to the cost of the goods to the wholesaler (the price for which the manufacturer sold them) the wholesaler's mark-up for handling costs, selling, overhead and profit. I would reverse.

Notes

(A) A manufacturer sold electric refrigerators. These were sold with warranties, and each purchaser was required to pay for the warranties the price of which was separately stated on the invoice to the manufacturer's vendees. It was held that the excise tax was payable on the total price charged, including the charge for a one year warranty on parts, and a five year warranty on sealed-in units. *General Motors Corp. v. United States,* 142 Ct.Cls. 842, 163 F.Supp. 854 (1958).

(B) In *United States v. Jefferson Electric Mfg. Co.,* 291 U.S. 386 (1934), the Court sustained the provisions of sec. 424 of the Revenue Act of 1928, which prevented a refund of an erroneously collected manufacturer's excise tax unless the taxpayer could show that he had not collected the tax from the consumer, or that he would repay to the consumer the amount of any refund which he might get from the Government. Similar provisions are now included in sec. 6416 of the 1954 Code. See "Federal Excise Tax Refunds," 56 Col.L.Rev. 77 (1956); Barton, "Refunds of Manufacturers' Excise Taxes," 18 Taxes 225 (1940). The provisions of sec. 6416 were extensively amended by the Excise Tax Technical Changes Act of 1958.

(C) *Processing Tax Refunds and "Windfall Tax."* The *Jefferson Electric* case had an importance which was not foreseen when it was decided. In 1936, the processing taxes which had been imposed by the first Agricultural Adjustment Act were held unconstitutional. *United States v. Butler,* 297 U.S. 1. Over a billion dollars of these taxes had been collected. In many, if not most, cases the tax was in effect "passed on" by the processors to the ultimate consumers, or even "passed back" to the producers. See An Analysis of the Effects of the Processing Taxes Levied Under the Agricultural Adjustment Act (Bureau of Agricultural Economics, 1937); Johnson, "A.A.A. Refunds: A Study in Tax Incidence," 37 Col.L.Rev. 910 (1937). In such cases, refunds to the processors would obviously be inequitable. To meet this situation, Congress included elaborate provisions in the Revenue Act of 1936 to govern refunds of amounts collected under the Agricultural Adjustment Act. Section 902 of that Act provides that "No refunds shall be made or allowed in pursuance of court decisions or otherwise, of any amount paid by or collected from any claimant as tax under the Agricultural Adjustment Act, unless the claimant establishes to the satisfaction of the Commissioner in accordance with regulations . . . that he bore the burden of such amount and has not been relieved thereof nor shifted such burden, directly or indirectly . . ." Section 906 of the Act established in the Treasury Department the Processing Tax Board of Review, with authority to pass upon the decisions of the Commissioner with respect to these refunds, and with provision for review by the courts as in cases from the Board of Tax Appeals. The validity of these provisions was upheld in *Anniston Manufacturing Co. v. Davis,* 301 U.S. 337 (1937). See also *Webre Steib Co. v. Commissioner,* 324 U.S. 164 (1945).

In many cases, the processing tax had been "passed on" by the processor, but had not in fact been paid to the Government often because the processor had obtained an injunction against the enforcement of the tax. (There were several thousand such injunction suits pending the decision in *United States v. Butler;* see *Rickert Rice Mills v. Fontenot,* 297 U.S. 110 (1936).) Congress dealt with this situation by including in the Revenue Act of 1936 what it called a tax on "Unjust Enrichment." This was commonly known as the windfall tax. It has now been repealed.

(D) *Admissions Tax.* In *Wilmette Park District v. Campbell,* 338 U.S. 411 (1949), it was held that the admissions tax (see sec. 4231 of the 1954 Code) was applicable to amounts paid for entrance to a bathing beach operated by a municipal park district. This result is now changed by the exemption granted by sec. 4233(a)(4) of the 1954 Code. A comprehensive discussion of the admissions tax is given in Lent, "The Admissions Tax," 1 Nat. Tax J. 31 (1948).

B. STAMP TAXES

Secs. 4301–4383 of the 1954 Code, as extensively amended by the Excise Tax Technical Changes Act of 1958

PENNSYLVANIA COMPANY FOR INSURANCES ON LIVES AND GRANTING ANNUITIES v. ROTHENSIES

United States Circuit Court of Appeals, Third Circuit, 1944. 146 F.2d 148.

JONES, CIRCUIT JUDGE. This appeal is by The Pennsylvania Company for Insurances on Lives and Granting Annuities (hereinafter referred to as the Pennsylvania Company or as the Trustee) from a judgment for the defendant entered by the court below in a suit instituted jointly by the Pennsylvania Company and the Wabash Railroad Company (an Ohio corporation) against the defendant Collector for the recovery of certain stamp taxes assessed against the Trustee and paid under protest. No claim for refund was filed by either the Wabash Railroad Company or by the receivers of its predecessor, the Wabash Railway Company (an Indiana corporation), and, at trial, the claim of the Wabash Railroad Company to a refund was not pressed. Only the plaintiff-Trustee has appealed.

The facts upon which the appellant bases its contentions in this court may be summarized from the supported findings of fact made by the learned trial judge as follows:

Between August 1, 1922, and February 1, 1929, the Wabash Railway Company, the Indiana corporation, in order to finance its acquisition of railroad equipment entered into a series of equipment trust agreements and leases with certain corporate trustees under the well-known "Philadelphia Car Trust" plan. See Rawle, 8 A.B.A.R., p. 277 (1885); Baldwin, American Railroad Law, p. 197 (1904).

In accordance with the plan, the designated trustee purchased the desired equipment from the vendors and paid for it out of the proceeds received from trust certificates which were issued by the trustee and sold to investors. The trust certificates carried semiannual dividend warrants and were to mature serially in annual installments. Upon the trustee's acquisition of the equipment, to which it took title in its own name, it leased the same to the Railway Company at an annual rental sufficient to pay the principal of the trust certificates at their respective maturities and also to pay all dividend warrants when due. By June 1, 1929, the Pennsylvania Company had become the successor trustee in all of the trust agreements and leases above referred to.

On December 31, 1931, the Wabash Railway Company was placed in the hands of receivers appointed by a United States District Court for Missouri. Nearly one-half of the Railway's rolling stock or other operating equipment then on hand had been acquired under the equipment trust agreements and leases above mentioned. It was, moreover, the Railway's newest equipment. The receivers being unable later to meet the rentals due under the extant equipment trust leases, the Court on May 20, 1933, entered an order directing them to make no "further payments on account of matured and/or maturing principal and/or interest upon any of" the equipment trust certificates as specifically identified in the order. The court order further directed the receivers to "negotiate with the Trustee and/or the holders of the above described Equipment Trust Obligations for the formulation of a plan for the refinancing or extension of the principal of said Equipment Trust Obligations upon terms that will preserve the equipment for use in the operation of the receivership estate and will readjust the amounts of the annual payments in amortization of the principal thereof."

The receivers did so negotiate and, as of June 1, 1933, entered into a written agreement with the holders of the subject outstanding equipment trust certificates. The agreement recited that the receivers had proposed, and that the subscribing certificate holders had approved, that "all installments of principal falling due under the Equipment Trust agreement in the years 1933 and 1934 be deferred for a period of three years * * *." Each subscribing certificate holder agreed not to take any action or require or request the Trustee to take any action and not to do any act which would cause the Trustee to take any action under the equipment trust because of the failure or refusal or default of the Railway or its receivers in respect of the rentals or principal due under the equipment trust agreement or lease.

Pursuant to the extension agreement, the subject equipment trust certificates were surrendered by the holders thereof to the treasurer of the receivers who endorsed on each certificate, in accordance with the agreement, a legend, stating in substance that the certificate was subject to the agreement and that copies of the agreement were on file with the Trustee and with the receivers. The certificates, when so endorsed, were returned to their respective owners or holders.

A similar extension agreement between the receivers of the Railway and holders of equipment trust certificates was executed as of February 1, 1936, and was carried into effect in the same way as was the agreement of June 1, 1933.

The receivers' treasurer with his staff acted as the Trustee's register, or transfer agent, with respect to the equipment trust

certificates during the receivership just as he had done as an officer of the Wabash Railway Company prior to the receivership and as he did as an officer of the successor Wabash Railroad Company after the receivership. While the Trustee did not sign the extension agreements, it knew that they were being negotiated and received copies of them following their execution which it placed in its files. It was not the policy of the Trustee to act in respect of the equipment trusts by repossessing itself of the equipment upon the lessee's default unless it was requested by the certificate holders so to do.

The extension of the maturity dates of the certificates was for the use and benefit of the receivers of the Railway Company and aided them in their operation of the railroad's properties and their administration of its affairs. The extensions also enured to the benefit of the Trustee in the administration of its trust duties.

The equipment trust certificates, which were on the usual engraved form used for corporate securities with dividend or interest coupons attached, were registered as to principal only.

The Commissioner of Internal Revenue, holding that the extensions of the indebtedness, worked by the agreements, constituted a renewal of the equipment trust certificates within the meaning of Sec. 800 of the Revenue Act of 1926, c. 27, 44 Stat. 9, as amended by Sec. 721(a) of the Revenue Act of 1932, c. 209, 47 Stat. 169,[1] accordingly assessed a commensurate tax against the Trustee which the Trustee paid to the defendant Collector under protest. The funds required for the payment were furnished by the receivers' check to the order of the Trustee which the Trustee in turn endorsed to the order of and delivered to the Collector.

That the trust certificates were corporate securities within the purview of the pertinent statutory provisions is hardly open to question. In fact, we understand the appellant to concede as

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[1] Sec. 800 of the Revenue Act of 1926 provided in material part as follows:

"Sec. 800. * * * there shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates * * * of indebtedness, and other documents, instruments, matters, and things mentioned and described in Schedule A * * *, or for or in respect of the vellum, parchment, or paper upon which such instruments, * * *, are written or printed, by any person who makes, signs, issues, sells, removes * * *, or for whose use or benefit the same are made, signed, issued, sold, removed, * * *, the several taxes specified in such schedule. * * *"

Schedule A of the Revenue Act of 1926 as amended by Sec. 721(a) of the Revenue Act of 1932 provided, inter alia, that

"I. Bonds of indebtedness: On all bonds, debentures, or certificates of indebtedness issued by any corporation and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities, on each $100 of face value or fraction thereof, 10 cents: Provided, That every renewal of the foregoing shall be taxed as a new issue: * * *."

much. In any event, we have no difficulty in concluding that the trust certificates were corporate securities and as such fall within the category of the statute. *Cf. Lederer v. Fidelity Trust Co.,* 267 U.S. 17, 21–22. The appellant's contentions, briefly stated, are rather (1) that the extension of the maturities of the certificates did not constitute a "renewal" of them and (2) that the Trustee, not having affirmatively made itself a party to the extension agreements, was not liable for the tax.

In the light of the undisputed facts as above recited, we fail to see how the Commissioner's action can possibly be thought to be error. The appellant's argument that the extensions were not renewals because the Trustee did not sign the extension agreements disregards the intended as well as actual effect of the completed arrangements. It will hardly be disputed that, after the agreements had been executed and the outstanding certificates had been made subject thereto, the Trustee was just as incapable for the extended period of three years of proceeding adversely under the equipment trust agreements and leases for a default in the payment of rentals by the Railway or its receivers as it would have been had it expressly made itself a party to the extensions. By the extension agreements, the cestuis effectually restrained the Trustee from taking action to repossess itself of the equipment because of the Railway's accrued and threatened defaults in the payment of rentals. The greatest value of the trust res lay in its continued utilization by the Railway as a going concern in the hands of its receivers. In fact, the court's direction to the receivers to negotiate maturity extensions with either the Trustee or the certificate holders or both had for its expressed purpose the preservation of "the equipment for use in the operation of the receivership estate * * *." We think it is clear that the agreements competently effected an extension of the trust certificates and the maturity of the indebtedness evidenced by them.

An extension of an indebtedness in such circumstances constitutes a renewal of the securities, which evidence the indebtedness, within the meaning of the statutory provisions now under consideration. The word "renewal", when used in like context, has been construed as synonymous with extension. See *Campbell River Timber Co. v. Vierhus,* 9 Cir., 86 F.2d 673, 674, 675; *Sheldon v. Mississippi Cottonseed Products Co.,* 81 F.2d 169, 171, 5 Cir., certiorari denied 297 U.S. 721. But, the appellant reminds us that tax statutes are to be strictly construed and are not to be extended by implication beyond the clear import of their words, citing *United States v. Merriam,* 263 U.S. 179, and *Gould v. Gould,* 245 U.S. 151. We are well aware of that rule of construction and mean to give it appropriate effect in any relevant setting. We do not apprehend, however, that the rule requires that we ar-

bitrarily reject the plain and reasonable meaning of a generic term in evident denial of the clear legislative intent which it is used to express. "The reach of a taxing act whose purpose is as obvious as the present is not to be restricted by technical refinements." *Raybestos-Manhattan, Inc. v. United States,* 296 U.S. 60, 63.

The Trustee's further contention is that, even though there was a renewal of the equipment trust certificates, still the Trustee was not assessable with the tax because it was not a party to the extension agreements which effected the renewal. In answer to this, it might reasonably be said that the Trustee's conduct during and after the negotiation and execution of the extension agreements required it to abide by their provisions. Where a Trustee's action in respect of its trust is permissibly directed and controlled by the desires of the cestuis, it would require more than passive inaction on the part of the Trustee in order that it might dissociate itself from an alteration in the trust validly made binding upon the cestuis. But, however that may be, after the trust certificates had been made subject to the extension agreement, the Trustee remained a party to the renewed certificates just as it had been before the renewal. The Act taxes a renewal as a new issue and a party to an issue, when once renewed, is assessable with the tax. Furthermore, with the renewal conceded, the Trustee must also concede that at least the receivers were liable for the tax. Yet it was the receivers who actually paid the tax by supplying the Trustee with the funds for that purpose. Substantially, therefore, the Trustee is without standing to claim a refund merely because the tax was assessed against it.

The judgment of the District Court is affirmed.

Notes

(A) The corresponding provisions in the 1954 Code are secs. 4311 and 4312, as amended by the Excise Tax Technical Changes Act of 1958.

(B) What is a corporate security? In *Fidelity Investment Association v. United States,* 78 Ct.Cl. 333, 5 F.Supp. 19 (1933), cert. den. 291 U.S. 685 (1934), it was held that installment investment certificates were not "known generally as corporate securities," and accordingly were not taxable. But cf. *Willcuts v. Investors' Syndicate,* 57 F.2d 811 (C.C.A.8th, 1932), cert. den. 287 U.S. 618 (1932). Such certificates are now exempted from tax by sec. 4314(a) of the 1954 Code, as amended.

UNITED STATES v. LESLIE SALT COMPANY

Supreme Court of the United States, 1956. 350 U.S. 383.

MR. JUSTICE HARLAN delivered the opinion of the Court.

On February 1, 1949, Leslie Salt Company, being in need of funds to meet maturing bank loans and for working capital, borrowed $3,000,000 from the Mutual Life Insurance Company of New York and $1,000,000 from the Pacific Mutual Life Insurance Company. As evidence of the indebtedness Leslie Salt delivered to each insurance company its "3¼% Sinking Fund Promissory Note Due February 1, 1964" in these amounts. The question presented is whether these instruments are subject to the documentary stamp taxes laid on "all bonds, debentures, or certificates of indebtedness issued by any corporation . . . ." under §§ 1800 and 1801 of the Internal Revenue Code of 1939.[1]

The Commissioner of Internal Revenue held the tax applicable, considering the two instruments to be "debentures" within the meaning of § 1801. However, in a tax recovery suit instituted by Leslie Salt, following payment of the tax under protest and the Commissioner's denial of a refund, the District Court and the Court of Appeals held the instruments not to be "debentures" or otherwise subject to stamp taxes. We brought the case here, 349 U.S. 951, to resolve the uncertainty left by lower court decisions as to whether § 1801 applies to corporate notes of this type.

Except as to amounts and payees, the two instruments in question were in identical terms, having these principal features: (1) each instrument carried the promissory note description already indicated; (2) each had a maturity of 15 years; (3) each carried interest of 3¼% payable August 1 and February 1 of each year on the unpaid balance; and (4) each was subject to the terms of an underlying agreement containing elaborate provisions for the protection of the note holders. Among those provisions was one under which each insurance company could require Leslie Salt to convert its note, which was

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1 Sec. 1800. "There shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned and described in sections 1801 to 1807, inclusive, or for or in respect of the vellum, parchment, or paper upon which such instruments, matters, or things, or any of them, are written or printed, the several taxes specified in such sections."

Sec. 1801. "On all bonds, debentures, or certificates of indebtedness issued by any corporation, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities, on each $100 of face value or fraction thereof, 11 cents: *Provided*, That every renewal of the foregoing shall be taxed as a new issue. . . ."

typewritten on ordinary white paper, into a series of new notes in denominations of $1,000 or multiples thereof, "either in registered form without coupons or in coupon form, and in printed or in fully engraved form." This option has not been exercised by either note holder.

These transactions with the two insurance companies constituted a variety of "private placement," a method of corporate financing which, because of its economies and conveniences, has become popular since the enactment of the Securities Act of 1933. The Government claims that these notes are taxable under § 1801 either as "debentures" or "certificates of indebtedness." The taxpayer, on the other hand, contends that these terms, undefined in the statute, do not include notes of the type here in issue. Taken in light of the legislative and administrative history of the statute, we agree with the taxpayer's contention.

"Debentures" and "certificates of indebtedness," along with other kinds of corporate securities, have been subject to stamp taxes since 1898, except for the period between 1902 and 1914. "Promissory notes" were also subject to stamp duties from 1898 to 1901 and from 1914 until 1924, when the tax was repealed; it has never been re-enacted. The tax on "promissory notes," however, was always carried in a section separate from that containing the tax on "bonds, debentures, or certificates of indebtedness," and was always at a rate lower than the tax on those instruments. Since promissory notes, debentures, and certificates of indebtedness all serve the same basic purpose—that is, as evidence of a debt—this former legislative distinction between promissory notes and the other instruments assumes significance in determining whether the present notes are taxable. For unless the earlier statutes were intended to impose two taxes on the same instrument, which we should not assume, or the present tax on debentures and certificates of indebtedness is broader in scope than that in effect in 1924, of which there is no indication, it would seem to follow that these notes should not now be taxed if they can be said to fall within the class of "promissory notes" on which the tax was repealed.

The Government argues that the repealed promissory note provision related only to ordinary short-term paper customarily used in day-to-day commercial transactions, and that it did not embrace notes, like those here involved, of large amounts, long maturity, and secured by an elaborate underlying agreement. See *General Motors Acceptance Corp. v. Higgins*, 161 F.2d 593, 595. The existence of these features, however, does not render either of the Leslie Salt instruments any the less a promissory note, as each was captioned. Nor do we find anything in the earlier legislation or in its history which satisfies us that this

type of note would not have been taxable at the lower rate provided in the promissory note section of the former statute. See *Niles-Bement-Pond Co. v. Fitzpatrick,* 213 F.2d 305, 308–310. Moreover, the administrative interpretations of the Treasury, discussed below, affirmatively indicate that they would have been considered taxable under that section.

But even assuming that these notes could not fairly be called "promissory notes," it does not follow that they must therefore be regarded as "debentures" or "certificates of indebtedness." That depends upon the meaning of those terms in the statute, and upon whether these notes, regardless of their descriptive caption, have the essential characteristics of "debentures" or "certificates of indebtedness," as those terms are used in the statute. *General Motors Acceptance Corp. v. Higgins, supra; Niles-Bement-Pond Co. v. Fitzpatrick, supra.* And in determining the scope of the statute, which has remained substantially unchanged since its first enactment, the Treasury's interpretations of it are entitled to great weight. *White v. Winchester Club,* 315 U.S. 32, 41.

The administrative history of the statute establishes that until 1947, when the *General Motors* case, *supra,* was decided, only those instruments were considered subject to the "debenture" tax which were issued (1) in series, (2) under a trust indenture, and (3) in registered form or with coupons attached. In other words, that tax was considered to apply only to marketable corporate securities, as that term is generally understood. Conversely, corporate promissory notes lacking any of those features, such as those issued by respondent, were taxed at the lower promissory note rate until that tax was repealed in 1924, and were not taxed thereafter until the Government's success in the *General Motors* case in 1947.

As early as 1918 the Treasury, in distinguishing instruments taxable at the "bond" and "debenture" rate from those taxable at the lower "promissory note" rate, then still in force, drew the line as follows:

"(3) Instruments containing the essential features of a promissory note, but issued by corporations in numbers under a trust indenture, either in registered form or with coupons attached, embodying provisions for acceleration of maturity in the event of any default by the obligor, for optional registration in the case of bearer bonds, for authentication by the trustee, and sometimes for redemption before maturity, or similar provisions, are bonds within the meaning of the statute, whether called bonds, debentures, or notes. However, a short-term instrument, although issued by a corporation under a trust indenture, may be regarded as a note if every instrument of such issue both (a) is payable to bearer and incapable of registration and (b) lacks

interest coupons and so requires presentation upon each payment of interest." T.D. 2713, May 14, 1918, 20 Treas.Dec.Int. Rev. 358 (1918).

When Congress in 1918 amended the existing statute by adding the language "and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities . . .," still found in § 1801, the Treasury recognized that this was in effect an enactment of its prior restrictive interpretation. The regulations which followed the repeal in 1924 of the tax on promissory notes did not purport to enlarge the scope of the tax on "bonds" or "debentures"; the Treasury adhered to the same interpretation issued under the previous statute. The regulations were amended in 1941 to the less specific, but not inconsistent form under which the present notes were taxed. Finally, explicit recognition that the attempt to tax notes not having the features of marketable corporate securities was a departure from prior Treasury practice is found in a ruling by the Commissioner of Internal Revenue that *General Motors* would not be applied retroactively:

"The Bureau has for a considerable period of time held that an instrument termed "note," not in registered form and issued without interest coupons, is not subject to the stamp tax upon issuance or transfer. Because of this long and uniform holding of the Bureau and the consequent reliance of corporations on these rulings, it has been concluded that, under the authority contained in section 3791(b) of the Internal Revenue Code, the decision in *General Motors Acceptance Corporation v. Higgins, supra,* will not be applied retroactively, except that any tax which has been paid on the issuance or transfer of instruments falling within the scope of the decision will not be refunded." M.T. 32, Cum.Bull. 1948–2, p. 160.

The term "certificate of indebtedness" has a similar administrative background. Since 1920 the Treasury has considered certificates of indebtedness as akin to bonds and debentures, including "only instruments having the general character of investment securities, as distinguished from instruments evidencing debts arising in ordinary transaction between individuals . . . ." L.O. 909, Sales Tax Rulings, December 1920 ST. 1–20–85; Regs. 55 (Art. 14), October 26, 1920, 22 T.D.Int.Rev. 502 (1920). The essence of an "investment security" is, of course, marketability, and this basic feature the Leslie Salt notes did not have. The Treasury itself has acknowledged that promissory notes lacking this quality have never been taxed as "certificates of indebtedness," M.T. 32, Cum.Bull. 1948–2, p. 160 (*ante*), and none of the lower court cases, including *General Motors, supra,* have regarded instruments such as the Leslie Salt

notes as being certificates of indebtedness. Moreover, it may be observed that in the stamp tax sections of the Internal Revenue Code of 1954 the words "certificates of indebtedness," consistently with this administrative history, have been eliminated as a separate taxable category of corporate instruments, and is employed simply as a term of art embracing all the instruments taxed, that is, "bonds," "debentures" and other instruments in registered form or with coupons. Internal Revenue Code of 1954, §§ 4311, 4381.

In contrast to the position it had consistently taken throughout the many years preceding the decision in the *General Motors* case, the Treasury now argues "that Congress intended in Section 1801 to cover all long-term debt obligations supported by elaborate protective covenants and that this is so regardless of details of the papers used, the language by which the transaction was consummated or the nature of the purchaser's business." This contention seems to stem from the belief that had the "private placement" method of financing been as widely known in 1924 as it is now, Congress would not have repealed the promissory note tax in its entirety, as it did. But if that be so it is nevertheless for Congress, and not the courts, to change the statute. We must deal with the statute as we find it, and if these instruments are neither "debentures" nor "certificates of indebtedness" they may not be taxed under the present statute. These taxes are based not upon the nature of the transaction involved, but upon the character of the instruments employed. As long ago as 1873, this Court said: "The liability of an instrument to a stamp duty, as well as the amount of such duty, is determined by the form and face of the instrument, and cannot be affected by proof of facts outside of the instrument itself." *United States v. Isham,* 17 Wall. 496, 504.

. . .

Construing the statute as we have, we conclude that the Leslie Salt notes are neither "debentures" nor "certificates of indebtedness" within its meaning. The fact that the agreement underlying these notes provides for the substitution of instruments which might qualify as debentures does not render these notes taxable, for until debentures are in existence the "debenture" tax cannot be imposed.

We hold these notes are not subject to stamp taxes under the statute.

Affirmed.

Note

There is a comment on the *Leslie Salt Company* case in 25 Geo.Wash.L.J. 109 (1956). See also Jensch, "Documentary Stamp Taxes: The Twilight Zone of Their Application to Large Corporate Loans," 33 Taxes 605 (1955), written prior to the *Leslie Salt Company* decision.

REVENUE RULING 54–345

Internal Revenue Service, 1954. 1954–2 Cum.Bull. 385.

Modifications made in debentures by a supplemental indenture which merely effect changes in the amount of working capital to be maintained by a corporation, in the security provisions of the debentures, and in the provisions relating to deposits to the sinking fund, do not effect such material changes in the terms of the debentures as to constitute a new issuance subject to original issue tax under sections 1800 and 1801 of the Internal Revenue Code. Cf. Rev.Rul. 54–60, I.R.B. 1954–7, 15.

Note

For many years the stock transfer tax was measured by the par value of the stock, with a stated tax rate for no-par stock. This meant that there was a good deal of pressure to issue stocks with low par values. It also meant that the tax bore no relation to the value of the shares. A sale of high par value stock at a low price would carry a high tax, while a sale of low par value stock at a high price would carry a low tax.

This was changed in 1958 by the Excise Tax Technical Changes Act of 1958. By sec. 4321 of the Code, as amended by that Act and again in 1959, the tax is measured by "the actual value of the certificates." Thus it no longer makes any difference whether the stock has a par value, or no par value, and if it has a par value, whether it is high or low—except that in no case does the tax exceed 8 cents a share.

PREMIER SHARES, INC. v. ROTHENSIES

United States Circuit Court of Appeals, Third Circuit, 1941. 117 F.2d 809.

MARIS, CIRCUIT JUDGE. Section 800, Title VIII of the Revenue Act of 1926, and Schedule A(3) as amended by Section 723 of the Revenue Act of 1932, 26 U.S.C.A.Int.Rev.Acts, pages 284, 290, imposes a stamp tax, inter alia, upon transfers of legal title to or rights to receive shares of stock in a corporation. Acting under these statutory provisions the Collector assessed a stock transfer tax upon Premier Shares, Inc., the plaintiff. The plaintiff paid the tax under protest and, after the rejection of its claim for refund, brought suit in the District Court for the Eastern District of Pennsylvania to recover the amount so paid. The case was

tried to a judge without a jury, the facts being stipulated. The district court denied recovery with respect to the disputed tax, granting the plaintiff judgment only for an amount admitted by the government to be refundable and this appeal followed. The facts, insofar as they are pertinent to the present appeal, are as follows:

By letter dated February 1, 1930, addressed to the attention of the incorporators and directors of the plaintiff, Boenning & Co. and Integrity Trust Company, hereinafter called the bankers, undertook to market at $12.50 per share 500,000 shares of the common stock of the plaintiff. By letter dated September 22, 1932, addressed to the board of directors of the plaintiff the bankers undertook to market an additional 500,000 shares. Between June 11, 1930, and January 16, 1934, the bankers sold 233,995 shares which were issued directly to purchasers obtained by the bankers and 45,279 shares which were issued to nominees of the bankers. The Collector assessed a tax of $3,919.36 upon the former and $851.96 upon the latter, treating the transactions as transfers by the bankers of their right to receive the shares thus sold.

The plaintiff would have us conclude from the stipulated facts that the bankers were simply agents for the sale of the plaintiff's capital stock and that what they did was merely to find purchasers, collect the purchase price, deduct a commission, and submit to the plaintiff, their principal, the necessary information for the issuance of certificates for the number of shares sold. Under such a construction of the facts there was no transfer of any title or right from the bankers to the purchasers and therefore no transfer subject to the stock transfer tax. The Collector, on the other hand, would have us conclude from the same evidentiary facts that the bankers had contracted for the right to subscribe to the plaintiff's capital stock, that they exercised this option when and as they found customers for the stock and that they thereupon directed the issuance of the stock. Under this view of the facts the bankers transferred their rights to subscribe for and receive the shares to the customers and this transfer was taxable.

In a letter dated February 1, 1930, written by the bankers and addressed to the incorporators and directors of the plaintiff, the bankers undertook "to use their best efforts to market to the public at the price of $12.50 per share" plaintiff's common stock, "the amount to be received by the undersigned as commission for such undertaking will be the sum of 99¢ per share, Premier Shares, Inc. to receive the net amount of $11.51 per share." In a letter dated September 24, 1930, the bankers referred to themselves as having been employed at a fixed commission to dispose of the stock. This appears to be the only positive evidence in

the record to substantiate the plaintiff's claim that an agency relationship was created. The plaintiff introduced no evidence from which the court could determine whether the bankers, in dealing with the public, purported to do so merely as selling agents, or whether the plaintiff ever issued to the purchasers of the stock a confirmation as seller.

To offset this evidence of agency the Collector points to the following facts in the stipulation: In a memorandum attached to the letter of agreement of February 1, 1930, the bankers refer to it as "an option to purchase," and refer to the stock issued as "under option." In the agreement the bankers obligate themselves to pay the expenses of the plaintiff's incorporation and of the stock offering. In a letter to the plaintiff dated July 18, 1930, the bankers confirmed "our purchase from you of 1,794 shares." Orders for stock were given by the bankers and cash was paid by them not later than the next business day or if payment was delayed interest was added. Payment was made by the bankers' own check. On certain dates the bankers had paid for and were entitled to receive large numbers of shares which were held by the plaintiff awaiting "transfer instructions" from the bankers.

The district court concluded that the bankers had an option to buy the plaintiff's stock under the agreements and that when they sold the stock to the public they transferred to the purchasers their right under the option to purchase and pay for it. Holding that this constituted a taxable transfer the court dismissed the complaint as to the tax here in controversy. We think that the conclusion of the district court as to the legal relationship between the bankers and the plaintiff with respect to the stock of the latter is fairly supported by the stipulated facts and the inferences reasonably to be drawn therefrom. The conclusion that sales by the bankers involved a transfer by them to their customers of their right to receive the shares necessarily follows.

It is now well settled that a transfer of the right to receive shares is subject to the stock transfer tax. *Founders General Corp. v. Hoey,* 300 U.S. 268; *Raybestos-Manhattan Co. v. United States,* 296 U.S. 60; *Ladner v. Pennroad Corp.,* 3 Cir., 97 F.2d 10, certiorari denied 305 U.S. 618. So in *Raybestos-Manhattan Co. v. United States, supra,* Mr. Justice Stone said (page 63): "The subject of the tax is not alone the transfer of ownership in shares of stock. It embraces transfers of rights to subscribe for or receive shares or certificates. * * * The reach of a taxing act whose purpose is as obvious as the present is not to be restricted by technical refinements." And again (page 62): "The stock transfer tax is a revenue measure exclusively. * * * While the statute speaks of transfers, it does not re-

quire that the transfer shall be directly from the hand of the transferor to that of the transferee. It is enough if the right or interest transferred is, by any form of procedure, relinquished by one and vested in another."

The judgment of the district court is affirmed.

REVENUE RULING 54–346

Internal Revenue Service, 1954. 1954–2 Cum.Bull. 386.

A beneficiary under a testamentary trust, which terminated upon his becoming of age, created a new trust after reaching his majority, to which was transferred the corpus of the testamentary trust. The trust assets were composed entirely of shares of stock. *Held,* since the right to receive the corpus of the testamentary trust vested in the beneficiary when he became of age, two transfer taxes were incurred under section 1802(b) of the Internal Revenue Code with respect to the transfer of such trust assets. The first tax is on the direct transfer from the trustee of the testamentary trust to the trustee under the new trust. The second tax is on the transfer by the beneficiary to the new trust of his right to receive the stock from the original trust, which right vested when he reached his majority. See *Raybestos-Manhattan, Inc., v. U. S.,* 296 U.S. 60, 56 S.Ct. 63, Ct.D. 1039, C.B. XIV–2, 400; and cf. Rev.Rul. 54–347, 1954–2 Cum.Bull. 386.

Notes

(A) In *United States v. Seattle-First Nat. Bank,* 321 U.S. 583 (1944), the Court held that the transfer of securities and real estate incident to the consolidation of a state bank and a national bank was a transfer "by operation of law" under the National Banking Act, and not subject to stamp taxes. Sec. 4343 of the 1954 Code now provides specifically for the transfers which are exempt because they are effected by operation of law.

(B) See Christy, The Transfer of Stock (3d ed., 1958). Chapter XXVI of this book is devoted to taxes on original issue of stock, and Chapter XXVII deals with taxes on transfers of stock.

C. SOCIAL SECURITY OR EMPLOYMENT TAXES

Secs. 3101–3308 of the 1954 Code

The Social Security taxes are of three sorts: (1) a tax on employees and on employers in all cases other than certain excepted employments; secs. 3101–3125 of the 1954 Code; (2) a tax on carriers and their employees; secs. 3201–3233 of the 1954 Code; and (3) a tax on employers of eight or more; secs. 3301–

3308 of the 1954 Code. The second is derived from the Carriers Taxing Act of 1937, c. 405, 50 Stat. 636, 639. The others relate to old age insurance, and unemployment insurance respectively.

BETTER BUSINESS BUREAU v. UNITED STATES

Supreme Court of the United States, 1945. 326 U.S. 279.

MR. JUSTICE MURPHY delivered the opinion of the Court.

Here our consideration is directed to the question of whether the petitioner, the Better Business Bureau of Washington, D. C., Inc., is exempt from social security taxes as a corporation organized and operated exclusively for scientific or educational purposes within the meaning of Section 811(b) (8) of the Social Security Act.[1]

From the stipulated statement of facts it appears that petitioner was organized in 1920 as a non-profit corporation under the laws of the District of Columbia. It has no shares of stock and no part of its earnings inures to the benefit of any private shareholder or individual. Its officers are elected annually from its membership; they have merely nominal duties and are paid no salary. Only the managing director and a small number of employees are paid. Membership is open to "any person, firm, corporation or association interested in better business ethics" as may be elected by the board of trustees and pay "voluntary subscriptions" or dues.

The charter of petitioner states that "the object for which it is formed is for the mutual welfare, protection and improvement of business methods among merchants and other persons engaged in any and all business or professions and occupations of every description whatsoever that deal directly or indirectly with the public at large, and for the educational and scientific advancements of business methods among persons, corporations or associations engaged in business in the District of Columbia so that the public can obtain a proper, clean, honest and fair treatment in its dealings or transactions with such merchants, tradesmen, corporations, associations or persons following a profession and at

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1 49 Stat. 620, 639, 42 U.S.C. § 1011(b): "The term 'employment' means any service, of whatever nature, performed within the United States by an employee for his employer, except—

. . . .

"(8) Service performed in the employ of a corporation, community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual."

An amendment to this definition, not here relevant, was added in 1939. The entire definition has been incorporated into Section 1426(b)(8) of the Internal Revenue Code.

the same time protecting the interest of the latter classes of businesses to enable such as are engaged in the same to successfully and profitably conduct their business and for the further purpose of endeavoring to obtain the proper, just, fair and effective enforcement of the Act of Congress approved May 29th, 1916, otherwise known as 'An Act to prevent fraudulent advertising in the District of Columbia.' "

In carrying out its charter provisions, petitioner divides its work roughly into five subdivisions:

(1) Prevention of fraud by informing and warning members and the general public of the plans and schemes of various types of swindlers.

(2) Fighting fraud by bringing general and abstract fraudulent practices to the attention of the public.

(3) Elevation of business standards by showing and convincing merchants that the application of "the doctrine of caveat emptor is not good business" and by showing and convincing them that misleading advertising, extravagant claims and price comparisons are not good business.

(4) Education of consumers to be intelligent buyers.

(5) Cooperation with various governmental agencies interested in law enforcement.

Information which the petitioner compiles is available to anyone without charge and is communicated to the members and the public by means of the radio, newspapers, bulletins, meetings and interviews. This information is also exchanged with the approximately eighty-five other Better Business Bureaus in the United States.

After paying the social security taxes for the calendar years 1937 to 1941, inclusive, petitioner filed claims for refunds, which were disallowed. This suit to recover the taxes paid was then filed by petitioner in the District Court, which granted a motion for summary judgment for the United States. The court below affirmed the judgment, 148 F.2d 14, and we granted certiorari, the Tenth Circuit Court of Appeals having reached a contrary result in *Jones v. Better Business Bureau of Oklahoma City,* 123 F.2d 767.

Petitioner claims that it qualifies as a corporation "organized and operated exclusively for . . . scientific . . . or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual" within the meaning of Section 811(b)(8) of the Social Security Act, and hence is exempt from payment of social security taxes. No serious assertion is made, however, that petitioner is

devoted exclusively to scientific purposes. The basic contention is that all of its purposes and activities are directed toward the education of business men and the general public. Merchants are taught to conduct their business honestly, while consumers are taught to avoid being victimized and to purchase goods intelligently. We join with the courts below in rejecting this contention.

It has been urged that a liberal construction should be applied to this exemption from taxation under the Social Security Act in favor of religious, charitable and educational institutions. Cf. *Trinidad v. Sagrada Orden,* 263 U.S. 578; *Helvering v. Bliss,* 293 U.S. 144. But it is unnecessary to decide that issue here. Cf. *Hassett v. Associated Hospital Service Corporation,* 125 F.2d 611 (C.C.A. 1). Even the most liberal of constructions does not mean that statutory words and phrases are to be given unusual or tortured meanings unjustified by legislative intent or that express limitations on such an exemption are to be ignored. Petitioner's contention, however, demands precisely that type of statutory treatment. Hence it cannot prevail.

In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes. It thus becomes unnecessary to determine the correctness of the educational characterization of petitioner's operations, it being apparent beyond dispute that an important if not the primary pursuit of petitioner's organization is to promote not only an ethical but also a profitable business community.

The exemption is therefore unavailable to petitioner.

The commercial hue permeating petitioner's organization is reflected in its corporate title and in the charter provisions dedicating petitioner to the promotion of the "mutual welfare, protection and improvement of business methods among merchants" and others and to the securing of the "educational and scientific advancements of business methods" so that merchants might "successfully and profitably conduct their business." Petitioner's activities are largely animated by this commercial purpose. Unethical business practices and fraudulent merchandising schemes are investigated, exposed and destroyed. Such efforts to cleanse the business system of dishonest practices are highly commendable and may even serve incidentally to educate certain persons. But they are directed fundamentally to ends other than that of education. Any claim that education is the sole aim of petition-

er's organization is thereby destroyed. See *Better Business Bureau v. District Unemployment Compensation Board,* 34 A.2d 614 (D.C.Mun.App.). . . .

For the foregoing reasons the judgment of the court below is

Affirmed.

Note

Under sec. 3121(k) of the 1954 Code religious, educational, or charitable organizations are authorized, under certain conditions, to waive the exemption from the tax imposed by sec. 3101, relating to old age contributions. Under this, most employees of such organizations are now covered by the old age insurance system.

BATT v. UNITED STATES

United States Circuit Court of Appeals, Ninth Circuit, 1945. 151 F.2d 949.

HEALY, CIRCUIT JUDGE. The appeal is from a judgment in favor of the United States in an action brought pursuant to § 3744 Internal Revenue Code, for the recovery of taxes for the year 1938, claimed to be payable as unemployment compensation under Title IX of the Social Security Act.

We summarize the facts as stipulated below. Appellant was a farmer owning or leasing some 800 acres of land in Idaho, on which he raised potatoes, onions, lettuce, carrots, and peas, as well as general crops with which the case is not concerned. He operated two processing sheds located off his farm near trackage. There he employed labor in the work of processing and preparing for market the specialized crops raised on his own farm, and in doing similar work for other farmers, who paid him for the service. The processing consisted primarily of a cleaning, sorting, grading, and packing operation, and included the loading of the produce on board cars and its icing for shipment. The produce was not changed by the operation. Approximately 25 per cent of the processed produce was raised and owned by appellant, and 75 percent thereof by other farmers. The produce from appellant's operations was intermingled with that of the other farmers and the whole went through the process together.

The produce, aside from that raised by appellant, was procured in the following ways. He purchased from the farmer-producer that portion of the latter's crop which was found to be marketable after being sorted and graded. To enable appellant and the farmer to determine the part purchased and to prepare the same for market, the farmer delivered his produce at appellant's sheds in bags as he took it from the field. Appellant handled, also, on a small scale, potatoes on consignment, in which case the farmer delivered the potatoes from the field as harvested. After proc-

essing the consigned potatoes, appellant sold them, and from the sale price deducted the expense, including a charge for processing and brokerage, paying the balance to the farmer. In the case of all produce, the culls were owned by and were returned to the producer. In respect to the lettuce, peas, and carrots not grown by appellant, the latter processed and sold them only on consignment, as in the case of some of the potatoes.

The processing operations were largely seasonal. No specialized equipment or equipment unavailable to farmers generally, was required. The labor was unskilled, and largely transient and temporary.[1]

The Social Security Act requires every employer to pay an excise tax, with respect to having individuals in his employ, equal to a stated percentage of the total wages payable. As originally enacted, and as the law stood in 1938, "agricultural labor" was excepted from the term "employment" as that term was defined in § 907(c), but the phrase "agricultural labor" was not itself defined.[2] The question here is whether the services rendered by the employees in the course of appellant's operations was "agricultural labor" within the meaning of the Act as it then stood. The court below answered the question in the negative.

In a suit brought by appellant to recover the excise taxes paid the State of Idaho with respect to the same employees for the same year, the Idaho court held the work to be agricultural and therefore exempt from coverage. *Batt v. Unemployment Compensation Division,* 63 Idaho 572, 123 P.2d 1004, 139 A.L.R. 1157.[3] We are urged to adopt the state court's view.

By Art. 206(1) of Treasury Regulations 90, the Department undertook to delimit specifically the scope of the statutory exemption. The Article is copied on the margin.[4] As will be ob-

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1 For a more exhaustive statement of the facts see opinion below, D.C., 59 F.Supp. 619.

2 By the Amendments of Aug. 10, 1939, 26 U.S.C.A.Int.Rev.Code § 1607, an elaborate definition of the term "agricultural labor" was inserted, but the amendments were prospective only. For a discussion of the legislative purpose of the amendments consult Chester C. Fosgate Co. v. United States, 5 Cir., 125 F.2d 775.

3 Under the state law, as under the Act of Congress, agricultural labor was exempted. Ch. 187, p. 316, 1937 Idaho Session Laws, § 19(g)(6).

4 "Art. 206(1). Agricultural labor.—The term 'agricultural labor' includes all services performed—

"(a) By an employee, on a farm, in connection with the cultivation of the soil, the raising and harvesting of crops, or the raising, feeding, or management of livestock, bees, and poultry; or

"(b) By an employee in connection with the processing of articles from materials which were produced on a farm; also the packing, packaging, transportation, or marketing of those materials or articles. Such services do not constitute 'agricultural labor,' however, unless they are performed by an employee of the owner or tenant of the farm on which the materials in their raw or natural state were produced, and unless such processing, packing,

served from a reading of it, services of the kind performed here were not considered by the Treasury to be agricultural labor unless performed "by an employee of the owner or tenant of the farm on which the materials in their raw or natural state were produced," and unless such processing is carried on as an incident to ordinary farming operations as distinguished from those of a manufacturing or commercial nature.

The Fifth Circuit, in *Chester C. Fosgate Co. v. United States,* 125 F.2d 775, on the basis of facts very similar to those involved here, approved the regulation as a reasonable and workable interpretation of the statutory term. *Cf.* also *Lake Region Packing Ass'n v. United States,* 5 Cir., 146 F.2d 157; *Jones v. Gaylord Guernsey Farms,* 10 Cir., 128 F.2d 1008. In *North Whittier Heights Citrus Ass'n v. N. L. R. B.,* 109 F.2d 76, certiorari denied 310 U.S. 632, we similarly construed and applied the term "agricultural laborers" as used in the National Labor Relations Act, 29 U.S.C.A. § 151 et seq. The individuals in the *North Whittier Heights* case were engaged in the processing, packing, and marketing of agricultural produce by methods and under circumstances analogous to those of the present case. It was there contended, as it is here, that the nature of the work is the sole criterion. The court thought, however, that the true test is the nature of the work modified by the custom of doing it; and it was concluded that the work, under the conditions performed, had an industrial hue.[5] The later case of *Stuart v. Kleck,* 9 Cir., 129 F.2d 400, decided by this court, is said to support the view advocated by appellant; but the two decisions are obviously distinguishable on their facts. Nor is *Kleck* decision at odds with the regulation quoted above.

Affirmed.

Notes

(A) See also Rev.Rul. 60–71, 1960–1 Cum.Bull. ——.

(B) In S.S.T. 359, 1939–1 Cum.Bull. 305, the Treasury ruled that payments of back pay made to employees pursuant to orders of the National Labor Relations Board were not "wages" within the meaning of the taxing provisions of the Social Security Act. This conclusion was disapproved in *Social Security Board v. Nierotko,* 327 U.S. 358 (1946), where the Court held that an employee was entitled to credit under the Social Security Act for such "back pay."

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packaging, transportation, or marketing is carried on as an incident to ordinary farming operations as distinguished from manufacturing or commercial operations.

"As used herein the term 'farm' embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms, plantations, ranches, ranges, and orchards.

"Forestry and lumbering are not included within the exception."

5 Cf. also, Idaho Potato Growers v. N. L. R. B., 144 F.2d 295 (C.C.A. 9th, 1944).

(C) Legal discussions of the Social Security Act and related taxes are numerous.[1] The social and economic questions raised by these statutes are almost limitless.[2] In the fiscal year 1958 the social security taxes produced a total of $8,644,386,000 in revenue. This was nearly double the amount collected in 1953, five years earlier. Under the present law, the taxes will considerably increase in amount in the years to come.

(D) The social security taxes apply only to "wages," and that term is defined in secs. 3121(a) and 3306(b) of the 1954 Code as including "all remuneration for employment," with several stated exceptions. The meaning of "employment" presents several difficult questions, which are spelled out in secs. 3121(b) and 3306(c). See also secs. 3121(d) and 3306(i).

(E) *Self-employment income.* Under secs. 1401–1403 of the 1954 Code there is a tax on self-employment income, designed to reach earnings from a trade or business which are not "wages," and thus to bring the self-employed within the social security system.

A self-employed insurance agent dies. Thereafter his renewal commissions are paid to his widow. The Treasury has ruled that these are not subject to self-employment tax. That tax applies only to income from a business carried on by the taxpayer. Here the wife is the taxpayer, but she carried on no trade or business. Rev.Rul. 59–162, 1959–1 Cum.Bull. 224.

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[1] See Hughes, Social Security Taxes (1941); Waldron, "Social Security Amendments of 1939: An Objective Analysis," 7 U. of Chi.L.Rev. 83 (1939); Orfield, "Federal Old Age and Survivors Insurance Under the Social Security Act," 18 Neb.L.Bull. 275 (1939); Gilchrist, "Tax Provisions of the Social Security Act," 22 Minn.L.Rev. 299 (1938); Orfield, "Taxation Under the Federal Social Security Act: Constitutional and Regulatory Aspects," 23 Corn.L.Q. 85 (1937); Layman, "Distinction Between Salesmen, Agents and Independent Contractors: Determination of Status Under Social Security Act," 15 Tax Mag. 409 (1937).

[2] See Peterson, "Misconceptions and Missing Perceptions of our Social Security System," 11 Transactions of the Society of Actuaries 812 (1959); Issues in Social Security—A Report to the Committee on Ways and Means (1946); Macy, "Social Security Taxes in the War Finance Program," 51 J.Pol.Econ. 135 (1943); Harris, Economics of Social Security (1941); Epstein, Insecurity (3d ed., 1936); Schwulst, "Economic Problems Arising From Social Security Taxes and Reserves," 27 Am.Econ.Rev. (Supp.) 120 (1937); Eliot, "Funds for the Future," 162 Atlantic Monthly 225 (Aug. 1938); Linton, "Insuring the Future," 162 Atlantic Monthly 544 (Oct. 1938); Barloon, "The Unemployment Trust Fund," 16 Harv.Bus.Rev. 351 (1938); Flynn, "The Social Security Reserve Swindle," 178 Harpers 238 (1939); Willcox, "Why the Old-Age Reserve Account is Indispensable Apart From Tax Problems," 52 Annalist 237 (Aug. 17, 1938); Willcox, "Social Security Taxation, Annual Appropriations and Anticipated Tax Receipts," 52 Annalist 270 (Aug. 24, 1938); Willcox, "Basic Policies Under Social Security Act, Argument Against System Analyzed," 52 Annalist 300 (Aug. 31, 1938). Much information on the operations of the statutes can be obtained from the Annual Reports of the Social Security Board, now incorporated into the Department of Health, Education and Welfare.

CHAPTER 14

GENERAL PROBLEMS

There are a number of general problems which are applicable to all or many federal taxes. Some of these have been involved in the material already presented. Two in particular may be mentioned:

(1) *The Status and Effect of Regulations and Rulings.* This has been involved in many of the cases presented in this book. Other material with respect to it has been referred to in Section D of Chapter 1, *supra,* p. 20.

(2) *The Relation of State Law to Federal Tax Questions.* This problem was involved in *Morgan v. Commissioner,* 309 U.S. 78 (1940), and *Lyeth v. Hoey, supra,* p. 192, among other cases. See also *Blair v. Commissioner,* 300 U.S. 5 (1936), and *Burnet v. Harmel,* 287 U.S. 103 (1932). There are discussions in "The Role of State Law in Federal Tax Determinations," 72 Harv.L.Rev. 1350 (1959); Colowick, "The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case," 12 Tax L. Rev. 213 (1957); Moscowitz, "Effect of State Court Decrees in Federal Tax Litigation," 43 A.B.A.J. 171 (1957). See also *Gallagher v. Smith,* 223 F.2d 218 (C.A.3d, 1955).[1]

(3) *Presumptions.* In recent years, a number of presumptions have been added to the statute. Problems with respect to these are discussed in Ness, "The Role of Statutory Presumptions in Determining Federal Tax Liability," 12 Tax L.Rev. 321 (1957); Rice, "Tax Fact and Fiction: Presumptions in Tax Cases," 1 South Dakota L.Rev. 56 (1956).

(4) There are also many practical problems. See, for example, Balter, "Problems Relating to Taxpayer's Obligation to Retain Adequate Books and Records for Federal Income Tax Purposes," 41 Marquette L.Rev. 107 (1957).

This chapter brings together a number of other problems of general application in tax controversies.[2]

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1 Earlier discussions may be found in Bartlett, "The Impact of State Law on Federal Income Taxation," 25 Chi.-Kent L.Rev. 103 (1947); Paul, "The Effect on Federal Taxation of Local Rules of Property," in Selected Studies in Federal Taxation 1 (1938). See also Barton, "The Effect of State Laws on Federal Tax Laws," 10 Tax Mag. 11 (1932). *Cf.* Cahn, "Local Law in Federal Taxation," 52 Yale L.J. 799 (1943).

2 Reference should also be made to Paul, "Motive and Intent in Federal Tax Law," in Selected Studies in Federal Taxation 255 (1938).

A. LIMITATIONS—ESTOPPEL, SET OFF AND RECOUPMENT

MORAN v. COMMISSIONER

United States Circuit Court of Appeals, First Circuit, 1933. 67 F.2d 601.

MORTON, CIRCUIT JUDGE. This is a petition on behalf of the taxpayer to review a decision by the Board of Tax Appeals (26 B.T.A. 1154), involving income taxes for the year 1928. The taxpayer, Thomas J. Moran, died in 1930, and the petition is prosecuted by his executrix.

There is no dispute as to the facts. The items in controversy consist of interest on certain certificates of deposit held by Mr. Moran. From time to time he deposited substantial amounts of money in two trust companies in Providence, R. I., and took therefor certificates of deposit. The earliest of these deposits appears to have been made in January, 1915, and the latest in March, 1928. The certificates bore interest, the rate of which might be varied on notice to the holder. No interest was credited on the companies' books to any particular certificate or person, until the certificate was presented, when the interest on it was figured and paid. Such payments were charged to a general interest-due account on the books of the trust companies.

For a number of years before 1928 Mr. Moran did not present some of his certificates and collected no interest on them. In March, 1928, he presented all of them and collected back and current interest on them amounting to about $24,000. As much of this interest as was earned in 1928 he returned as income for that year. He did not return the amount received as interest for prior years; nor had he reported such interest in the years in which it accrued. Neither party contends that Moran acted fraudulently; and there is no such finding by the Board of Tax Appeals. The Commissioner included all the interest received in 1928 as income for that year; and the Board of Tax Appeals affirmed his action.

It is argued for the executrix that the interest was "constructively received" by Mr. Moran in the years in which it accrued, and should therefore be taxed in those years, and not as a lump sum in 1928. For the earlier years the tax is outlawed, and as to them the contention is that the tax has been lost. The Commissioner urges (1) that Moran, having elected to treat the interest as not received until actually collected, and having acted on that election in making his tax returns for the prior years in which the interest accrued, cannot now be heard to say that the interest should have been returned and taxed in the years in which it became payable, and that Moran's estate stands in no better position, and (2) that the interest in question was not received by Moran until he collected it.

In our opinion, the Commissioner's first contention must be sustained. Assuming—as we are bound to assume on the record before us—that Moran acted honestly, his conduct, in not including the interest as it accrued in his early returns, evidenced an election on his part to treat it as not received until actually collected. Having made that election and acted on it in his dealings with the government, and having had the benefit of that position, and rights having become fixed on that basis, we are clear that his estate ought not now to be allowed to repudiate the position so definitely taken nor to assert rights inconsistent therewith. *Magee v. United States,* 282 U.S. 432; *Davis v. Wakelee,* 156 U.S. 680; *Casey v. Galli,* 94 U.S. 673, 680; *Hartwell Mills v. Rose,* 61 F.2d 441 (C.C.A. 5). "If it was a mistake, of which there is no evidence, it was one made by the defendant, of which he took the benefit, and the plaintiff the loss, and it is too late to correct it." Curtis, J., *Philadelphia, W. & B. R. Co. v. Howard,* 13 How. 307, at 337. The present case is not different in principle from those in which a taxpayer, having the right to file either one or two different sorts of returns, makes his choice and files his returns accordingly. It is settled that he cannot afterwards change. *Radiant Glass Co. v. Burnet,* 60 App.D.C. 351, 54 F. 2d 718. This is so even where the taxpayer, under a mistake of law, was unaware that he had the right to choose. *Buttolph v. Commissioner,* 29 F.2d 695 (C.C.A.7).

It is not a case in which income, unquestionably received, was not included in the tax returns. There are provisions in the statutes dealing with such situations. Here there was room for real doubt as to whether the interest, which was obtainable but was not actually in hand, ought to be returned. Moran honestly took the position—which the Commissioner now takes—that the interest was not received before actually collected. It was open to Moran to choose which way he would deal with the matter. It might also have been open to the Commissioner to challenge Moran's right to take the course which he followed. But, where the Commissioner does not challenge it, but on the contrary accepts it, and, as we have said, rights have become fixed, Moran could not repudiate his election, nor can his estate do so.

It is unnecessary to decide the second point. We may say, however, that the doctrine of "constructive receipt" seems to us of doubtful value. The question really is whether money or property is received within the meaning of the tax statutes; and we doubt whether discussion of it is clarified by the fictitious approach.

The decision of the Board of Tax Appeals is

Affirmed.

Notes and Problems

(A) But *cf. Ross v. Commissioner,* 169 F.2d 483 (C.C.A.1st, 1948), which virtually overrules the *Moran* case. In *Estate of George Kingdon,* 9 T.C. 838 (1947), it was held that the estate was estopped to deny that property was community property, where the decedent before his death had filed an affidavit asserting that the property was community property and had obtained a refund of income taxes on that ground.

See Atlas, "The Doctrine of Estoppel in Tax Cases," 3 Tax L.Rev. 71 (1947).

(B) In *Bigelow v. Bowers,* 68 F.2d 839 (C.C.A.2d, 1934), cert. den. 292 U.S. 656 (1934), the taxpayer had received a stock dividend in 1916. In accordance with the statute of that time, he returned the value of the dividend as income. In 1918, he sold both the old and the new stock, receiving less than the original cost of the old stock plus the value of the dividend. He claimed a loss in 1918, in accordance with the regulations. After the Supreme Court decided *Eisner v. Macomber* in 1920, the Commissioner ruled that the receipt of the stock dividend had not been income, so that only the original cost of the old shares was available to the taxpayer on the sale of the stock in 1918. This resulted in a gain, which the Commissioner determined accordingly; and he was sustained by the courts.[1]

(C) For an instance of estoppel operating against the Government, see *Vestal v. Commissioner,* 152 F.2d 132 (App.D.C.1945). For discussion, see Manning, "The Application of the Doctrine of Estoppel against the Government in Federal Tax Cases," 30 N.C. L.Rev. 356 (1952); Newman, "Should Official Advice be Reliable?—Proposals as to Estoppel and Related Doctrines in Administrative Law," 53 Col.L.Rev. 374 (1953).

(D) Note the provisions of sec. 6501 of the 1954 Code for a three-year limitation period.[2] Do not overlook sec. 6501(e) which extends the period to six years where an item in excess of twenty-five per cent of the gross income has been omitted. Even more, do not overlook section 6501(c) which allows the assessment of tax without any limitation period in the case of a false or fraudulent return or where no return has been filed.

(E) A corporation claims to be exempt from tax under what is now sec. 501(c)(5) of the 1954 Code, and the Commissioner issues a formal ruling that it is exempt. Accordingly it files no returns. Fifteen years later, a succeeding Commissioner concludes that the earlier ruling was erroneous, and rules that the corporation is not exempt. May he collect back taxes for the entire period without limitation on the ground that no return was

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1 These problems are thoroughly discussed in Maguire and Zimet, "Hobson's Choice and Similar Practices in Federal Taxation," 48 Harv.L.Rev. 1281 (1935). See also McConnell, "The Doctrine of Recoupment in Federal Taxation," 28 Va.L.Rev. 577 (1942); Karol, "The Doctrine of Estoppel," 23 Taxes 1159 (1945); Jones, "Estoppel in Tax Litigation," 26 Georgetown L.J. 868 (1938); Jackson, "Equity in the Administration of Federal Taxes," 13 Tax Mag. 641 (1935).

2 See "The Statute of Limitations in Tax Cases and Mistaken Advice by Officials," 61 Yale L.J. 1214 (1952).

filed? See *Southern Maryland Agricultural Fair Ass'n v. Commissioner,* 40 B.T.A. 548 (1939).

Suppose a return is duly filed but not sworn to when an oath was required. Does this start the statute running? See *Lucas v. Pilliod Lumber Co.,* 281 U.S. 245 (1930). In *Burford Oil Co. v. Commissioner,* 153 F.2d 745 (C.C.A.5th, 1946), the return was signed only by the taxpayer's treasurer but not also by the president or other officer as then required by the regulations. It was held that it was "no return" and that a delinquency penalty was due.

Under the present law returns no longer need to be sworn to (sec. 6065 of the 1954 Code), and corporate returns need be signed by only one officer or authorized representative. Sec. 6062. But the same problem may arise where an unsigned return is filed. Such a return will be "no return," with the consequences that follow from that fact.

(F) In *Germantown Trust Co. v. Commissioner,* 309 U.S. 304 (1940), the Court held that the filing of a fiduciary return on Form 1041 was sufficient to start the statute running, although a corporation return on Form 1120 should have been filed. But in *Commissioner v. Lane-Wells Co.,* 321 U.S. 219 (1944), a corporation failed to file a separate personal holding company return on Form 1120H, although it did file the ordinary income tax return on Form 1120. It was held that no statute of limitations ran as to the personal holding company tax, and that the 25% penalty for failing to file a return was mandatory.

(G) *Recovery of Erroneous Refund.* Even if the taxpayer is able to persuade the Commissioner to give him a refund, the matter may not be closed. Under section 7405 of the 1954 Code, the Government may recover the amount of any erroneous refund, but only by suit, and only if the suit is begun "within two years after the making of such refund"—unless the refund was induced by fraud. See sec. 6532(b) of the 1954 Code. In *United States v. Wurts,* 303 U.S. 414 (1938), it was held that this statutory period "does not begin to run against the Government when a claim is erroneously allowed. It begins to run from the date of payment."

COMMISSIONER v. GOOCH MILLING & ELEVATOR CO.

Supreme Court of the United States, 1943. 320 U.S. 418.

MR. JUSTICE MURPHY delivered the opinion of the Court.

The jurisdiction of the Board of Tax Appeals to determine and to apply a prior tax overpayment against a tax deficiency for a particular year is the sole question presented by this case. The Board held that it did not possess such jurisdiction, but the court below reversed, 133 F.2d 131. We granted certiorari, 319 U.S. 737, the problem being one of importance in the administration of the revenue laws.

An audit made in 1938 of the books of the respondent corporation disclosed an erroneous valuation of its inventory of June 30,

1935.[1] Because of this error, respondent had been overassessed and had overpaid its income and excess profits taxes for the 1935 fiscal year. This excess payment was not subject to refund because barred by the statute of limitations. On the basis of the adjusted inventory, however, the Commissioner determined that there was a tax deficiency for the 1936 fiscal year. The overpayment of the prior fiscal year exceeded the amount of this deficiency. On appeal to the Board for a redetermination of the deficiency, the respondent sought in its amended petition to have the 1935 overpayment applied as an offset or recoupment against the 1936 deficiency. The Board, consistent with its past decisions, refused to grant this relief "for jurisdictional reasons."

We hold that the Board's position was correct and that it had no jurisdiction to determine or to apply any overpayment of the taxes for the 1935 fiscal year against the 1936 deficiency.

The Board is but "an independent agency in the Executive Branch of the Government,"[2] and the legislative pattern of its jurisdiction is clear and unambiguous. The Board is confined to a determination of the amount of deficiency or overpayment for the particular tax year as to which the Commissioner determines a deficiency and as to which the taxpayer seeks a review of the deficiency assessment. Internal Revenue Code, §§ 272, 322(d). It has no power to order a refund or credit should it find that there has been an overpayment in the year in question. *United States ex rel. Girard Trust Co. v. Helvering,* 301 U.S. 540, 542. Section 272(g) of the Internal Revenue Code specifically provides that "the Board in redetermining a deficiency in respect of any taxable year shall consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid."

The Board's want of jurisdiction to apply the doctrine of equitable recoupment in this case is manifest from these statutory provisions. The Commissioner assessed a deficiency only for the 1936 fiscal year and it was this assessment of which the respondent sought a review. The Board thus had jurisdiction to do no more than redetermine the 1936 deficiency distinct from any overpayment or underpayment in any prior or subsequent year. There was no occasion here for the Board to exercise its power under § 272(g) to consider any facts relating to the taxes for the

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[1] The respondent filed its tax returns on the basis of a fiscal year ending on June 30. The inventory of June 30, 1935, was common to successive years, being the closing inventory for the 1935 fiscal year and the opening inventory for the 1936 fiscal year.

[2] 53 Stat. 158, 26 U.S.C. § 1100.

1935 fiscal year.[3] The redetermination of the tax liability for the 1936 fiscal year was in no way dependent on any prior tax assessment or overpayment. Likewise, neither the fact that the prior overpayment could no longer be refunded nor the fact that the overpayment exceeded the amount of the deficiency had any relevance whatever to the redetermination of the correct tax for the 1936 fiscal year. The respondent, in other words, was seeking to have the 1935 overpayment used, not as an aid in redetermining the 1936 deficiency, but as an affirmative defense or offset to that deficiency.[4] This necessarily involved a determination of whether there was an overpayment during the 1935 fiscal year. The absolute and unequivocal language of the proviso of § 272(g), however, placed such a determination outside the jurisdiction of the Board. Thus to allow the Board to give effect to an equitable defense which of necessity is based upon a determination foreign to the Board's jurisdiction would be contrary to the expressed will of Congress.[5]

We are not called upon to determine the scope of equitable recoupment when it is asserted in a suit for refund of taxes in tribunals possessing general equity jurisdiction. Cf. *Bull v. United States,* 295 U.S. 247; *Stone v. White,* 301 U.S. 532. But its use in proceedings before the Board is governed by the circumscribed jurisdiction of that agency. The Internal Revenue Code, not general equitable principles, is the mainspring of the Board's jurisdiction. Until Congress deems it advisable to allow the Board to determine the overpayment or underpayment in any taxable year other than the one for which a deficiency has been assessed, the Board must remain impotent when the plea of equitable recoupment is based upon an overpayment or underpayment in such other year. The judgment of the court below is therefore reversed and that of the Board of Tax Appeals is affirmed.

Reversed.

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3 The Board has not hesitated to exercise its jurisdiction under § 272(g) to consider the taxes for other taxable years insofar as relevant to the correct redetermination of the deficiency in question. See Evens & Howard Fire Brick Co. v. Commissioner, 8 B.T.A. 867; Commercial Trust Co. v. Commissioner, 8 B.T.A. 1138; D. N. & E. Walter & Co., Inc. v. Commissioner, 10 B.T.A. 620; J. C. Blair Co. v. Commissioner, 11 B.T.A. 673; Greenleaf Textile Corp. v. Commissioner, 26 B.T.A. 737, affirmed 65 F.2d 1017; W. M. Ritter Lumber Co. v. Commissioner, 30 B.T.A. 231, 277.

4 As we said in Bull v. United States, 295 U.S. 247, 262, "recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded."

5 Before § 272(g) of the Internal Revenue Code was enacted, the Board held that it had jurisdiction to determine an overpayment for a year as to which no deficiency had been found by the Commissioner and to apply that overpayment against the liability for the year as to which he had found a deficiency, thus giving effect to the doctrine of equitable recoupment. Appeal of E. J. Barry, 1 B.T.A. 156. Soon thereafter, however, Congress passed § 274(g) of the Revenue Act of 1926 [now § 272(g) of the Internal Revenue Code] taking such jurisdiction away from the Board.

Notes

(A) In *Gooch Milling and Elevator Co. v. United States,* 75 F. Supp. 474 (Ct.Cl.1948), the court first held that the taxpayer could not recover in the Court of Claims when it had previously filed a petition with the Tax Court. However, this opinion was withdrawn, and a new trial granted, and on June 1, 1948, the Court of Claims handed down a new decision on this question, in favor of the taxpayer. *Gooch Milling and Elevator Co. v. United States,* 111 Ct.Cl. 576, 78 F.Supp. 94 (1948). This was based on what is now found in secs. 1311–1314 of the 1954 Code. Thus the long and persistent effort of the taxpayer in the *Gooch* case was at last rewarded.

(B) In *Elbert v. Johnson,* 164 F.2d 421 (C.C.A.2d, 1947), it was held that no suit might be brought in the District Court for recoupment after a petition to the Tax Court had been filed, even though the Tax Court did not have jurisdiction to grant recoupment.

(C) In *United States v. Herring,* 240 F.2d 225 (C.A.4th, 1957), it appeared that an income tax deficiency was determined against a taxpayer several years after his death. The statute of limitations was open as far as the income tax deficiency was concerned because waivers had been filed by the decedent's executrix. However, the deficiency in income tax gave rise to an estate tax deduction for the decedent's estate. The time for filing a claim for refund of estate tax had expired when the income tax deficiency was determined.

The court held that the administratrix might set off the amount of the excessive estate tax paid against the income tax deficiency, since both arose out of the same transaction. The income tax had been paid, and the administratrix was allowed to recover the portion of it equivalent to the estate tax claim on the ground that this was an overpayment of income tax. See 43 Va.L.Rev. 742 (1957).

ROTHENSIES v. ELECTRIC STORAGE BATTERY CO.

Supreme Court of the United States, 1946. 329 U.S. 296.

MR. JUSTICE JACKSON delivered the opinion of the Court.

This case represents an effort, thus far successful, to obtain advantage by way of recoupment of a claim for tax refund long since barred by the statute of limitations. The facts of this singular situation are not in dispute. From April 1919 to April 1926 the Electric Storage Battery Company paid excise taxes on the sale of storage batteries in the belief, shared by the Government, that such sales were subject to tax. In July of 1926 the company asserted otherwise and filed a refund claim. It asked refund only of that part of the taxes which it had paid between 1922 and 1926. Refund of the taxes paid earlier which the company now seeks to recoup was then barred by the statute of limitations and no claim ever has been filed for their refund and no action ever

was begun for their recovery. Suit was brought, however, against the Collector for refund of the taxes paid after July 1922; judgment therefor was obtained in the District Court and affirmed by the Circuit Court of Appeals. The Government finally settled by refund of $1,395,515.35, of which $825,151.52 represented tax and the balance interest.

During the years that the refunded excise tax was being collected, the taxpayer deducted it from income before calculation of its income tax, thereby deriving substantial benefits. The Commissioner, therefore, treated the refund as income for 1935, the year in which it was received, and because of it assessed additional income and excess profits taxes which with interest thereon totaled $229,805.34. The taxpayer paid the deficiency, filed claim for refund, and after it was rejected sued the Collector. It contended that the refund from the Government was not income to the taxpayer but that if it were so considered taxpayer should be permitted, as against the additional tax caused by its inclusion, to recoup the amount of the barred excise taxes which it had paid between 1919 and 1922. Both courts below correctly held that the refund was properly assessed as income. *Cf. Security Flour Mills Co. v. Commissioner,* 321 U.S. 281; *Freihofer Baking Co. v. Commissioner,* 151 F.2d 383. Both have held, however, that the income tax liability for 1935 should be extinguished by recoupment of the 1919 to 1922 excise taxes. The gravity of this holding to the administration of the tax laws led us to grant certiorari. *Rothensies v. Electric Storage Battery Co.,* 327 U.S. 774.

It is not contended that there is any statutory warrant for allowing barred tax refund claims by way of recoupment or otherwise.[1] Authority for it is said to be found in case law and taxpayer relies chiefly on two decisions of this Court, *Bull v. United States,* 295 U.S. 247, and *Stone v. White,* 301 U.S. 532. The essence of the doctrine of recoupment is stated in the *Bull* case: "recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded." 295 U.S. 247, 262. It has never been thought to allow one transaction to be offset against another, but only to permit a transaction which is made the subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.

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1 Indeed, the applicable provisions of the Revenue Act of 1928 seem to direct a result opposite to that asked by respondent. Section 608 provides that "A refund of any portion of an internal-revenue tax (or any interest, penalty, additional amount, or addition to such tax) made after the enactment of this Act, shall be considered erroneous—(a) if made after the expiration of the period of limitation for filing claim therefor, unless within such period claim was filed; . . ." Section 609(b) provides, "A credit of an overpayment in respect of any tax shall be void if a refund of such overpayment would be considered erroneous under section 608." 45 Stat. 874, 875. And cf. McEachern v. Rose, 302 U.S. 56.

The application of this general principle to concrete cases in both of the cited decisions is instructive as to the limited scope given to recoupment in tax litigation. In both cases a single transaction constituted the taxable event claimed upon and the one considered in recoupment. In both, the single transaction or taxable event had been subjected to two taxes on inconsistent legal theories, and what was mistakenly paid was recouped against what was correctly due. In *Bull v. United States,* the one taxable event was receipt by executors of a sum of money. An effort was made to tax it twice—once under the Income Tax Act as income to the estate after decedent's death and once under the Estate Tax Act as part of decedent's gross estate. This Court held that the amount of the tax collected on a wrong theory should be allowed in recoupment against an assessment under the correct theory.[2] In *Stone v. White,* likewise, both the claim and recoupment involved a single taxable event, which was receipt by an estate of income for a period. The trustees had paid the income tax on it but this Court held it was taxable to the beneficiary. Assessment against the beneficiary had meanwhile become barred. Then the trustees sued for a refund, which would inure to the beneficiary. The Court treated the transaction as a whole and allowed recoupment of the tax which the beneficiary should have paid against the tax the Government should not have collected from the trustees. Whatever may have been said indicating a broader scope to the doctrine of recoupment, these facts are the only ones in which it has been applied by this Court in tax cases.

The Government has argued that allowance of the claim of recoupment involved here would expand the holding in the *Bull* case. The Circuit Court of Appeals agreed that in the *Bull* case "the main claim and recoupment claim were more closely connected than they are here." *Electric Storage Battery Co. v. Rothensies,* 152 F.2d 521, 524. But the court nevertheless allowed the claim because it considered that this Court had introduced the doctrine of recoupment into tax law and that it was "based on concepts of fairness." 152 F.2d 521, 524. It said it saw no reason for narrowly construing the requirement that both claims originate in the same transaction. We think this misapprehends the limitations on the doctrine of recoupment as applied to tax law and it leads us to state more fully reasons for declining to expand the doctrine beyond the facts of the cited cases.

It probably would be all but intolerable, at least Congress has regarded it as ill-advised, to have an income tax system under which there never would come a day of final settlement and which

[2] But the Court emphasized that refund of the incorrect tax was not barred by the statute at the time the Government proceeded for collection of the correct tax.

required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. Hence, a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.

We have had recent occasion to point out the reason and the character of such limitation statutes. "Statutes of limitation, like the equitable doctrine of laches, in their conclusive effects are designed to promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them." *Order of Railroad Telegraphers v. Railway Express Agency,* 321 U. S. 342, 348–9. "They are by definition arbitrary, and their operation does not discriminate between the just and the unjust claim, or the voidable [avoidable] and unavoidable delay. They have come into the law not through the judicial process but through legislation." *Chase Securities Corp. v. Donaldson,* 325 U.S. 304, 314.

As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out.[3] They tempt the equity-minded judge to seek for ways of relief in individual cases.

But if we should approve a doctrine of recoupment of the breadth here applied we would seriously undermine the statute of limitations in tax matters. In many, if not most, cases of asserted deficiency the items which occasion it relate to past years closed by statute, at least as closely as does the item involved here. *Cf. Hall v. United States,* 43 F.Supp. 130. The same is true of items which form the basis of refund claims. Every assessment of deficiency and each claim for refund would invite a search of the taxpayer's entire tax history for items to recoup.

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[3] In American Light & Traction Co. v. Harrison, 142 F.2d 639, the court did not allow recoupment to the Government. But, judiciously, it said, "Although here a hardship on the Government results from the taxpayer's inconsistency, the correlative provisions of this same statute will, in the converse of the instant situation, work an equal hardship on the taxpayer." 142 F.2d 639, 643. Whether or not the statute, §§ 608 and 609 of the Revenue Act of 1928, be taken to compel the conclusion we reach in this case, the court's recognition that both parties to taxation are affected impartially, though perhaps harshly, by policy of repose has application here. It may easily be overlooked, when the unfairness of the Government's retaining incorrectly collected monies of respondent is stressed, that the statute of limitations is primarily an instrument of fairness.

This case provides evidence of the extent to which this would go. When this suit was brought in 1943, the claim pleaded as a recoupment was for taxes collected over twenty years before and for over sixteen years barred by the statute. That claims dead so long can be resurrected under this doctrine, is enough to show its menace to the statute of limitations—at least as to those taxpayers whose affairs by accident or design take such shape that they can avail themselves of recoupment remedies. Moreover, we have held that the Tax Court has no jurisdiction to consider recoupment. *Commissioner v. Gooch Milling & Elevator Co.,* 320 U.S. 418. Hence, the availability of the remedy would depend on diverting the litigation to the district courts.

We cannot approve such encroachments on the policy of the statute out of consideration for a taxpayer who for many years failed to file or prosecute its refund claim. If there are to be exceptions to the statute of limitations, it is for Congress rather than for the courts to create and limit them.

The judgment below is

Reversed.

MR. JUSTICE MURPHY is of the opinion, in which MR. JUSTICE BLACK and MR. JUSTICE RUTLEDGE join, that the judgment below should be affirmed. He believes that the claims for refund of the illegal assessments exacted from 1919 to 1922 arise out of the same subject matter as was involved in the Government's demand for additional taxes for 1935, thereby making applicable the rule of *Bull v. United States,* 295 U.S. 247.

Notes

(A) In *Stone v. White,* 301 U.S. 532 (1937), it appeared that the trustees of a trust had paid a tax which should have been paid by the beneficiary. The trustees brought suit to recover the tax after the statute of limitations had run against the Government's right to collect the tax from the beneficiary. It was held that the Government's claim against the beneficiary could be used as a defense against the suit by the trustee. But in *McEachern v. Rose,* 302 U.S. 56 (1937), an executor returned certain receipts as income in 1929, 1930 and 1931. He should have returned them all in 1928. He sued for refunds for the later years at a time when the deficiency for 1928 was barred. The Government sought to set off the deficiency relying on *Stone v. White.* The Court held that the set-off, or credit, was barred by the provisions of section 607 and 609 of the Revenue Act of 1928 (corresponding to secs. 6401 and 6514(b) of the 1954 Code).

See "Recoupment in Federal Taxation: When Does It Apply?" 44 Va.L.Rev. 981 (1958).

(B) A comprehensive effort to provide for the solution of some of these problems is found in secs. 1311–1314 of the 1954 Code, formerly appearing as sec. 3801 of the 1939 Code, and first enacted as sec. 820 of the Revenue Act of 1938. These sections are

of considerable complexity. They have been applied in relatively few cases. See, e. g., *Albert W. Priest Trust*, 6 T.C. 221 (1946); *Taxeras v. United States*, 269 F.2d 283 (C.A.8th, 1959). See "Sections 1311–15 of the Internal Revenue Code: Some Problems in Administration," 72 Harv.L.Rev. 1536 (1959); Rothe, "A Comparison of the Basis Provision of 1939 Code Section 3801 with the 1954 Law," 35 Taxes 97 (1957).[1]

(C) The taxpayer received payments on debenture notes which she treated as returns of capital for the years 1932 through 1942. In 1946 and 1947 she received final payments which, her basis having been exhausted, she treated as long-term capital gains. In 1950, after the statute of limitations had run on all years prior to 1947, she sought a refund of the tax paid for 1947. The basis of her claim was that the payments received in 1932–42 had in fact been dividends, so that her entire basis remained available, and offset the payments received in 1946 and 1947. Relying on former Section 3801, the Government counterclaimed for the tax on the dividends, and the case went to judgment on this basis. Thereafter, in 1953 the taxpayer brought the present suit for a refund for 1946. This was allowed. The Court held that the Government's position that the 1932–42 payments were dividends was inconsistent with the capital gain treatment for 1946, and that the taxpayer's claim came within former Section 3801 when the Government's inconsistent position was adopted in the earlier case. *United States v. Rosenberger*, 235 F.2d 69 (C.A.8th, 1956), commented on in 70 Harv.L.Rev. 1483 (1957).

B. RES JUDICATA

The Supreme Court held that the doctrine of res judicata was applicable to federal tax cases in *Tait v. Western Maryland Railway Co.*, 289 U.S. 620 (1933). The question in this case was whether a successor railway company was entitled to amortize discount on bonds issued by predecessor companies. In a previous case, involving the tax years 1918 and 1919, the Board of Tax Appeals had refused such a deduction, but its decision had been reversed by the Circuit Court of Appeals. The present case involved the years 1920–1925. The Court held that the prior decision was res judicata, and was therefore controlling in determining tax liability for the later years.

1 Earlier references include "Relief from the Statute of Limitations in Tax Cases under Section 3801," 40 Va.L.Rev. 773 (1954); Landman, "Tax Relief from the Statute of Limitations," 5 Tax L.Rev. 547 (1950); Wilkinson, "Mitigation of the Effect of the Statute of Limitations under the Income Tax Laws," 27 Tex.L.Rev. 818 (1949); Maguire, Surrey and Traynor, "Section 820 of the Revenue Act of 1938," 48 Yale L.J. 509, 719 (1939); Kent, "Mitigation of the Statute of Limitations in Federal Tax Cases," 27 Calif.L.Rev. 109 (1939).

COMMISSIONER v. SUNNEN

Supreme Court of the United States, 1948. 333 U.S. 591.

MR. JUSTICE MURPHY delivered the opinion of the Court.

The problem of the federal income tax consequences of intra-family assignments of income is brought into focus again by this case.

The stipulated facts concern the taxable years 1937 to 1941, inclusive, and may be summarized as follows:

The respondent taxpayer was an inventor-patentee and the president of the Sunnen Products Company, a corporation engaged in the manufacture and sale of patented grinding machines and other tools. He held 89% or 1,780 out of a total of 2,000 shares of the outstanding stock of the corporation. His wife held 200 shares, the vice-president held 18 shares and two others connected with the corporation held one share each. The corporation's board of directors consisted of five members, including the taxpayer and his wife. This board was elected annually by the stockholders. A vote of three directors was required to take binding action.

The taxpayer had entered into several non-exclusive agreements whereby the corporation was licensed to manufacture and sell various devices on which he had applied for patents.[1] In return, the corporation agreed to pay to the taxpayer a royalty equal to 10% of the gross sales price of the devices. These agreements did not require the corporation to manufacture and sell any particular number of devices; nor did they specify a minimum amount of royalties. Each party had the right to cancel the licenses, without liability, by giving the other party written notice

[1] The various devices involved were as follows:

(1) A cylinder grinder. The taxpayer applied for a patent on Nov. 17, 1927, and was issued one on Dec. 4, 1934. The royalty agreement to manufacture and sell this device was dated Jan. 10, 1928. This agreement expired on Jan. 10, 1938; a renewal agreement in substantially the same terms was then executed for the balance of the life of the patent, which ends on Dec. 4, 1951.

(2) A pinhole grinder. The taxpayer applied for a patent on Dec. 4, 1931, and was issued one on June 13, 1933. The royalty agreement to manufacture and sell this device was dated Dec. 5, 1931.

(3) A crankshaft grinder. The taxpayer applied for a patent on May 22, 1939, and was issued one on May 6, 1941. The royalty agreement to manufacture and sell this device was dated June 20, 1939.

(4) Another crankshaft grinder. The taxpayer applied for a patent on Dec. 29, 1939. He assigned this application to his wife on Dec. 29, 1942, and she was issued a patent on Jan. 26, 1943. The royalty agreement to manufacture and sell this device was dated June 20, 1939.

The taxpayer remained the owner of the first three patents throughout the year 1941, and he remained the owner of the patent application on the fourth device throughout that year.

of either six months or a year.[2] In the absence of cancellation, the agreements were to continue in force for ten years. The board of directors authorized the corporation to execute each of these contracts. No notices of cancellation were given. Two of the agreements were in effect throughout the taxable years 1937–1941, while the other two were in existence at all pertinent times after June 20, 1939.

The taxpayer at various times assigned to his wife all his right, title and interest in the various license contracts.[3] She was given exclusive title and power over the royalties accruing under these contracts. All the assignments were without consideration and were made as gifts to the wife, those occurring after 1932 being reported by the taxpayer for gift tax purposes. The corporation was notified of each assignment.

In 1937 the corporation, pursuant to this arrangement, paid the wife royalties in the amount of $4,881.35 on the license contract made in 1928; no other royalties on that contract were paid during the taxable years in question. The wife received royalties from other contracts totaling $15,518.68 in 1937, $17,-318.80 in 1938, $25,243.77 in 1939, $50,492.50 in 1940, and $149,-002.78 in 1941. She included all these payments in her income tax returns for those years, and the taxes she paid thereon have not been refunded.

Relying upon its own prior decision in *Estate of Dodson v. Commissioner*, 1 T.C. 416,[4] the Tax Court held that, with one

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2 Six months' notice was provided in the agreement dated Jan. 10, 1928, covering the cylinder grinder. The other three agreements provided for one year's notice of cancellation.

3 On Jan. 8, 1929, the taxpayer assigned to his wife "all my rights, title and interest in and to the Royalty which shall accrue hereafter to me" upon the royalty contract of Jan. 10, 1928, with respect to the cylinder grinder device. Since the Commissioner of Internal Revenue raised some question as to the sufficiency and completeness of this assignment, the taxpayer executed a further assignment on Dec. 21, 1931, this second assignment confirmed the first one and stated further that his wife was assigned "all of my right, title and interest in and to said royalty contract of January 10. 1928. . . . And I hereby state that the royalties accruing under said royalty contract have heretofore been and are hereafter the sole and exclusive property of the said Cornelia Sunnen [his wife], and hereby declare that said royalties shall be paid to the said Cornelia Sunnen or to her order, and that she shall have the sole right to collect, receive, receipt for, retain or sue for said royalties."

Assignments similar in form and substance to the assignment of Dec. 21, 1931, were made as to the other three royalty contracts.

4 In the Dodson case, Dodson owned 51% of the stock of a corporation and his wife owned the other 49%. He was the owner of a formula and trade mark. Pursuant to a contract which he made with the corporation, the corporation was given the exclusive use of the formula and trade mark for 5 years, renewable for a like period. Dodson was to receive in return a royalty measured by a certain percentage of the net sales. He then assigned a one-half interest in the contract to his wife, retaining his full interest

exception, all the royalties paid to the wife from 1937 to 1941 were part of the taxable income of the taxpayer. 6 T.C. 431. The one exception concerned the royalties of $4,881.35 paid in 1937 under the 1928 agreement. In an earlier proceeding in 1935, the Board of Tax Appeals dealt with the taxpayer's income tax liability for the years 1929–1931; it concluded that he was not taxable on the royalties paid to his wife during those years under the 1928 license agreement. This prior determination by the Board caused the Tax Court to apply the principle of *res judicata* to bar a different result as to the royalties paid pursuant to the same agreement during 1937.

The Tax Court's decision was affirmed in part and reversed in part by the Eighth Circuit Court of Appeals. 161 F.2d 171. Approval was given to the Tax Court's application of the *res judicata* doctrine to exclude from the taxpayer's income the $4,881.35 in royalties paid in 1937 under the 1928 agreement. But to the extent that the taxpayer had been held taxable on royalties paid to his wife during the taxable years of 1937–1941, the decision was reversed on the theory that such payments were not income to him. Because of that conclusion, the Circuit Court of Appeals found it unnecessary to decide the taxpayer's additional claim that the *res judicata* doctrine applied as well to the other royalties (those accruing apart from the 1928 agreement) paid in the taxable years. We then brought the case here on certiorari, the Commissioner alleging that the result below conflicts with prior decisions of this Court.

If the doctrine of *res judicata* is properly applicable so that all the royalty payments made during 1937–1941 are governed by the prior decision of the Board of Tax Appeals, the case may be disposed of without reaching the merits of the controversy. We accordingly cast our attention initially on that possibility, one that has been explored by the Tax Court and that has been fully argued by the parties before us.

It is first necessary to understand something of the recognized meaning and scope of *res judicata,* a doctrine judicial in origin. The general rule of *res judicata* applies to repetitious suits involving the same cause of action. It rests upon considerations of economy of judicial time and public policy favoring the establishment of certainty in legal relations. The rule provides that when a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit and their privies are thereafter bound "not only as to every matter which was offered and received to sustain or defeat the claim or demand,

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in the formula and trade mark. The Tax Court held that his dominant stock position permitted him to cancel or modify the contract at any time, thus rendering him taxable on the income flowing from his wife's share in the contract.

but as to any other admissible matter which might have been offered for that purpose." *Cromwell v. County of Sac,* 94 U.S. 351, 352. The judgment puts an end to the cause of action, which cannot again be brought into litigation between the parties upon any ground whatever, absent fraud or some other factor invalidating the judgment. See von Moschzisker, "Res Judicata," 38 Yale L.J. 299; Restatement of the Law of Judgments, §§ 47, 48.

But where the second action between the same parties is upon a different cause or demand, the principle of *res judicata* is applied much more narrowly. In this situation, the judgment in the prior action operates as an estoppel, not as to matters which might have been litigated and determined, but "only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered." *Cromwell v. County of Sac, supra,* 353. And see *Russell v. Place,* 94 U.S. 606; *Southern Pacific R. Co. v. United States,* 168 U.S. 1, 48; *Mercoid Corp. v. Mid-Continent Co.,* 320 U.S. 661, 671. Since the cause of action involved in the second proceeding is not swallowed by the judgment in the prior suit, the parties are free to litigate points which were not at issue in the first proceeding, even though such points might have been tendered and decided at that time. But matters which were actually litigated and determined in the first proceeding cannot later be relitigated. Once a party has fought out a matter in litigation with the other party, he cannot later renew that duel. In this sense, *res judicata* is usually and more accurately referred to as estoppel by judgment, or collateral estoppel. See Restatement of the Law of Judgments, §§ 68, 69, 70; Scott, "Collateral Estoppel by Judgment," 56 Harv.L.Rev. 1.

These same concepts are applicable in the federal income tax field. Income taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action. Thus if a claim of liability or non-liability relating to a particular tax year is litigated, a judgment on the merits is *res judicata* as to any subsequent proceeding involving the same claim and the same tax year. But if the later proceeding is concerned with a similar or unlike claim relating to a different tax year, the prior judgment acts as a collateral estoppel only as to those matters in the second proceeding which were actually presented and determined in the first suit. Collateral estoppel operates, in other words, to relieve the government and the taxpayer of "redundant litigation of the identical question of the statute's application to the taxpayer's status." *Tait v. Western Md. R. Co.,* 289 U.S. 620, 624.

But collateral estoppel is a doctrine capable of being applied so as to avoid an undue disparity in the impact of income tax liability. A taxpayer may secure a judicial determination of a par-

ticular tax matter, a matter which may recur without substantial variation for some years thereafter. But a subsequent modification of the significant facts or a change or development in the controlling legal principles may make that determination obsolete or erroneous, at least for future purposes. If such a determination is then perpetuated each succeeding year as to the taxpayer involved in the original litigation, he is accorded a tax treatment different from that given to other taxpayers of the same class. As a result, there are inequalities in the administration of the revenue laws, discriminatory distinctions in tax liability, and a fertile basis for litigious confusion. Compare *United States v. Stone & Downer Co.,* 274 U.S. 225, 235–236. Such consequences, however, are neither necessitated nor justified by the principle of collateral estoppel. That principle is designed to prevent repetitious lawsuits over matters which have once been decided and which have remained substantially static, factually and legally. It is not meant to create vested rights in decisions that have become obsolete or erroneous with time, thereby causing inequities among taxpayers.

And so where two cases involve income taxes in different taxable years, collateral estoppel must be used with its limitations carefully in mind so as to avoid injustice. It must be confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged. *Tait v. Western Md. R. Co.,* supra. If the legal matters determined in the earlier case differ from those raised in the second case, collateral estoppel has no bearing on the situation. See *Travelers Ins. Co. v. Commissioner,* 161 F.2d 93. And where the situation is vitally altered between the time of the first judgment and the second, the prior determination is not conclusive. See *State Farm Ins. Co. v. Duel,* 324 U.S. 154, 162; 2 Freeman on Judgments (5th ed. 1925) § 713. As demonstrated by *Blair v. Commissioner,* 300 U.S. 5, 9, a judicial declaration intervening between the two proceedings may so change the legal atmosphere as to render the rule of collateral estoppel inapplicable.[5] But the intervening decision need not necessarily be that of a state court, as it was in the *Blair* case. While such a state court decision may be considered as having changed the facts for federal tax litigation purposes, a modification or growth in legal principles as enunciated in intervening decisions of this Court may also effect a significant change in the situation. Tax inequality can result as readily from neglecting legal modulations by this Court as

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[5] See also Henricksen v. Seward, 135 F.2d 986; Monteith Bros. Co. v. United States, 142 F.2d 139; Pelham Hall Co. v. Hassett, 147 F.2d 63; Commissioner v. Arundel-Brooks Concrete Corp., 152 F.2d 225; Corrigan v. Commissioner, 155 F.2d 164. Compare Grandview Dairy v. Jones, 157 F.2d 5.

from disregarding factual changes wrought by state courts. In either event, the supervening decision cannot justly be ignored by blind reliance upon the rule of collateral estoppel. *Henricksen v. Seward,* 135 F.2d 986, 988–989; *Pelham Hall Co. v. Hassett,* 147 F.2d 63, 68–69; *Commissioner v. Arundel-Brooks Concrete Corp.,* 152 F.2d 225, 227; *Corrigan v. Commissioner,* 155 F.2d 164, 165; and see *West Coast Life Ins. Co. v. Merced Irr. Dist.,* 114 F.2d 654, 661–662; contra: *Commissioner v. Western Union Tel. Co.,* 141 F.2d 774, 778. It naturally follows that an interposed alteration in the pertinent statutory provisions or Treasury regulations can make the use of that rule unwarranted. *Tait v. Western Md. R. Co., supra,* 625.[6]

Of course, where a question of fact essential to the judgment is actually litigated and determined in the first tax proceeding, the parties are bound by that determination in a subsequent proceeding even though the cause of action is different. See *The Evergreens v. Nunan,* 141 F.2d 927. And if the very same facts and no others are involved in the second case, a case relating to a different tax year, the prior judgment will be conclusive as to the same legal issues which appear, assuming no intervening doctrinal change. But if the relevant facts in the two cases are separable, even though they be similar or identical, collateral estoppel does not govern the legal issues which recur in the second case.[7] Thus the second proceeding may involve an instrument or transaction identical with, but in a form separable from, the one dealt with in the first proceeding. In that situation, a court is free in the second proceeding to make an independent examination of the legal matters at issue. It may then reach a different result or, if consistency in decision is considered just and desirable, reliance may be placed upon the ordinary rule of *stare decisis.* Before a party can invoke the collateral estoppel doctrine in these circumstances, the legal matter raised in the second proceeding must involve the same set of events or documents and the same bundle of legal principles that contributed to the rendering of the first judgment. *Tait v. Western Md. R. Co., supra.* And see Griswold, "Res Judicata in Federal Tax Cases," 46 Yale L.J. 1320; Paul and Zimet, "Res Judicata in Federal Taxation," appearing in Paul, Selected Studies in Federal Taxation (2d series, 1938), p. 104.

It is readily apparent in this case that the royalty payments growing out of the license contracts which were not involved in the earlier action before the Board of Tax Appeals and which concerned different tax years are free from the effects of the

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6 And see Commissioner v. Security-First Nat. Bank, 148 F.2d 937.

7 Stoddard v. Commissioner, 141 F.2d 76, 80; Campana Corporation v. Harrison, 135 F.2d 334; Engineer's Club of Philadelphia v. United States, 42 F. Supp. 182.

collateral estoppel doctrine. That is true even though those contracts are identical in all important respects with the 1928 contract, the only one that was before the Board, and even though the issue as to those contracts is the same as that raised by the 1928 contract. For income tax purposes, what is decided as to one contract is not conclusive as to any other contract which is not then in issue, however similar or identical it may be. In this respect, the instant case thus differs vitally from *Tait v. Western Md. R. Co., supra,* where the two proceedings involved the same instruments and the same surrounding facts.

A more difficult problem is posed as to the $4,881.35 in royalties paid to the taxpayer's wife in 1937 under the 1928 contract. Here there is complete identity of facts, issues and parties as between the earlier Board proceeding and the instant one. The Commissioner claims, however, that legal principles developed in various intervening decisions of this Court have made plain the error of the Board's conclusion in the earlier proceeding, thus creating a situation like that involved in *Blair v. Commissioner, supra.* This change in the legal picture is said to have been brought about by such cases as *Helvering v. Clifford,* 309 U.S. 331; *Helvering v. Horst,* 311 U.S. 112; *Helvering v. Eubank,* 311 U.S. 122; *Harrison v. Schaffner,* 312 U.S. 579; *Commissioner v. Tower,* 327 U.S. 280; and *Lusthaus v. Commissioner,* 327 U.S. 293. These cases all imposed income tax liability on transferors who had assigned or transferred various forms of income to others within their family groups, although none specifically related to the assignment of patent license contracts between members of the same family. It must therefore be determined whether this *Clifford-Horst* line of cases represents an intervening legal development which is pertinent to the problem raised by the assignment of the 1928 agreement and which makes manifest the error of the result reached in 1935 by the Board. If that is the situation, the doctrine of collateral estoppel becomes inapplicable. A different result is then permissible as to the royalties paid in 1937 under the agreement in question. But to determine whether the *Clifford-Horst* series of cases has such an effect on the instant proceeding necessarily requires inquiry into the merits of the controversy growing out of the various contract assignments from the taxpayer to his wife. To that controversy we now turn.[8]

The judgment below must therefore be reversed and the case remanded for such further proceedings as may be necessary in light of this opinion.

Reversed.

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8 The portion of the opinion dealing with the effect of the assignment, and holding that the taxpayer remained taxable on the assigned income, is omitted.

MR. JUSTICE FRANKFURTER and MR. JUSTICE JACKSON believe the judgment of the Tax Court is based on substantial evidence and is consistent with the law, and would affirm that judgment for reasons stated in *Dobson v. Commissioner,* 320 U.S. 489, and *Commissioner v. Scottish American Co.,* 323 U.S. 119.

Notes and Problem

(A) See Branscomb, "Collateral Estoppel in Tax Cases: Static and Separable Facts," 37 Tex.L.Rev. 584 (1959); Lore, "Res Judicata in the Tax Laws," 34 Taxes 455 (1956); Sellin, "The Sunnen Case: A Logical Terminus to the Issue of Res Judicata in Tax Cases," 4 Tax L.Rev. 363 (1949).

In *Consolidated Edison Co. v. United States,* 279 F.2d 152 (C.A. 2d, 1960), the facts related to different years but were otherwise identical. These were held to be "separable," and the court refused to give *res judicata* effect to a prior decision of the Court of Claims.

(B) In *United States v. International Building Co.,* 345 U.S. 502 (1953), noted in 67 Harv.L.Rev. 167 (1953), the first proceeding, pending in the Tax Court, was settled by a stipulation filed by the parties. The Tax Court held no hearings. No briefs were filed or argument presented. The court held that this decision was not res judicata as to the same issue (depreciation) in a later year. The court said that "the issues raised by the pleadings" in the former case were not "submitted to the Tax Court for determination or determined by that court." There was no "adjudication of the merits."

(C) In *Sage v. United States,* 250 U.S. 33 (1919), the taxpayer first sued the Collector and lost. He thereafter brought a suit against the United States in the Court of Claims to recover the same tax. The Court held that the parties were different and that the first judgment was not res judicata.[1] This conclusion was adhered to in *United States v. Nunnally Investment Co.,* 316 U.S. 258 (1942).[2] This result was changed by the addition in 1942 of what is now sec. 7422(c) of the 1954 Code.

(D) The taxpayer owned timber on March 1, 1913, so that its gain from later sales depended on the value on that date. In a proceeding involving the year 1924, the Board determined this value. In a later case in court involving the year 1925, a different value was fixed, more favorable to the taxpayer. Still later the taxes for the year 1928 are involved in court. Both sides rely on res judicata. What result should be reached? See *Donald v. J. J. White Lumber Co.,* 68 F.2d 441 (C.C.A.5th, 1934). *Cf. Treinies v. Sunshine Mining Co.,* 308 U.S. 66 (1939).

(E) The law before the *Sunnen* case was discussed in Paul and Zimet, "Res Judicata in Federal Taxation," 32 Ill.L.Rev. 139

1 See also Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1932); Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (1940). Cf. George Moore Ice Cream Co. v. Rose, 289 U.S. 373, 381-383 (1933).

2 See also United States v. Kales, 314 U.S. 186 (1941), where it was held that a suit against one collector to recover taxes for 1919, did not bar a later suit against the United States to recover an amount of taxes paid in the same year to a different collector.

(1937), also in Paul, Selected Studies in Federal Taxation, 104 (1939); Griswold, "Res Judicata in Federal Tax Cases," 46 Yale L.J. 1320 (1937).

C. COLLECTION—TRANSFEREES

See, generally, Wolfer and Cohan, "The United States as a Creditor for Taxes," 35 Taxes 684 (1957).

UNITED STATES v. METROPOLITAN LIFE INS. CO.

United States Circuit Court of Appeals, Second Circuit, 1942. 130 F.2d 149.

L. HAND, CIRCUIT JUDGE. The plaintiff appeals from a summary judgment dismissing its complaint upon the following state of facts. The defendant, Nistle, became indebted to the plaintiff for deficiencies in income taxes assessed against him for the years 1926 and 1932. Part of these he paid but there remained due more than $5,000, none of which the plaintiff has been able to collect. Nistle had taken out two life insurance policies in the defendant company, one of which—for $1,000—was payable to "the legal representatives of the insured," and gave the insured the option of taking the cash surrender value upon surrender of the policy. The second policy was for $30,000 and the original beneficiary was "L. Mable" (sic) "Nistle, wife"; it was taken out in 1923 and in May, 1935 the beneficiary was changed so that the wife became entitled to receive one-third of the proceeds and a daughter two-thirds. This policy also gave the insured the option of taking the cash surrender value upon surrender of the policy. In both policies the insured reserved the power to change the beneficiaries. On November 25, 1936 the plaintiff served notice on the insurance company in Pennsylvania that Nistle owed $8,187.72 in taxes, and that it thereby levied upon all his property then in its possession and all sums of money owed by it to him; and it repeated this demand on December 4, 1937. This action was commenced on May 20, 1940, by the personal service of a summons and complaint upon the insurance company; and upon Nistle on May 31, 1940 in Pennsylvania (the last having been authorized by an order of the District Court for the Southern District of New York). The policies are not in the possession of the insurance company, and the plaintiff has of course not offered to surrender them. The plaintiff asserts that its notices to the insurance company constituted a valid levy under § 3692, and that the company's refusal to pay was a refusal to "surrender" Nistle's "property" in its "possession," which made it liable for the cash surrender value under § 3710(b).

The distress authorized by § 3690 is different from anything known to the common-law, both because it authorizes a sale of the property seized, and because it extends to other personalty

than chattels. The first of these modifications appeared as early as 1791 in § 23 of Chapter XV of the laws of that year, 1 St.L. p. 204, which provided for the "distress and sale of goods of the person or persons refusing or neglecting to pay" certain excises imposed by that act. This was repeated in § 28 of the Revenue Act of 1864, 13 St.L. p. 233, the phrase there being: "it shall be lawful for such collector * * * to collect the said duties or taxes * * * by distraint and sale of the goods, chattels, or effects of the persons delinquent as aforesaid." The procedure then prescribed was in substance like the present, except that nothing was said about a levy. In 1866, 14 Stat. 107, § 9, Congress made the second modification by including in the leviable property "stocks, securities, and evidences of debt"; and a levy was required to be made "upon all property and rights to property * * * belonging to" the taxpayer. The provision for a levy became § 3188 of the Revised Statutes without change and remains unchanged at the present time (§ 3692). In 1924, § 1016 of the Revenue Act of 1924, 43 St.L. 343, the words "bank accounts," were interpolated between "securities" and "evidences of debt," and that too has remained unchanged (§ 3690). Section 3710 was not passed until 1926 when it was added in its present form. § 1114(e) and (f) of the Revenue Act of 1926, 44 St.L. 117. .

Thus it appears that between 1866 and 1926 if the taxpayer's chattels were in the possession of a third person who refused to surrender them, the collector had no means of enforcing a surrender and could not make delivery in performance of his contract of sale. This put the Treasury at a disadvantage in such cases, because all that the collector could do was to sell the taxpayer's bare title, which was likely to fetch a much lower price than the chattels if delivered. Section 3710 was apparently passed to remedy this; it imposed a direct duty upon the recalcitrant holder to surrender them, and authorized an action against him for their value if he refused. It is true that this action was called a "penalty," but it was really not that, for title would undoubtedly pass upon payment, so that the holder would suffer no loss. But the action would at once determine the validity of the taxpayer's title and dispense with the need of any sale by liquidating the value of the chattels. It seems very probable that the words "rights to property," introduced in 1866 at the same time that choses in action were first made leviable, were meant to cover them as distinguished from chattels described as "property"; at least it is hard to understand what else could have been intended. Certainly the same phrase when used in § 3710(a) means what it does in § 3692, especially since it has a function, when understood to refer to choses in action. That function is to cover cases in which third persons, such as trustees or the like,

are in possession of documents—notes, bonds, etc.—which belong to the taxpayer; perhaps it also covers cases in which the chose in action is not embodied in any document, even though that strains the meaning of the word "possession" a little. The collector is entitled to a "surrender"—which will include an assignment when that is necessary—in order to realize the full value of the chose in action upon a sale. The remedy runs pari passu with that given in the case of chattels.

That is not enough, however, for the plaintiff's position here; Nistle has the policies and he is the holder of the obligation, i. e. the right to demand their cash surrender value. To succeed, the plaintiff must maintain that the insurer—the promisor—is in "possession" either of Nistle's "property," or of his "right to property." The second can be at once eliminated—indeed the plaintiff does not urge it—obviously it would be nonsense to say that a promisor is in "possession" of a "right to property" against himself, or that by performing he "surrenders" that right. But the plaintiff does argue that the promisor has "possession" of the promisee's "property" and that by performance—payment—he "surrenders" it. Obviously that is legally a solecism; the promisee has no interest in a penny of the promisor's property; the promisor may even perform through a third person, whom he induces to advance the money to the promisee on the promisor's credit. The promisee can do nothing but compel performance, and performance is not fastened upon any part of the promisor's property. However, such an argument is not final; people use language loosely—even in statutes—and it would not be too great a strain on the word "property" to make it serve for the promisor's performance if the setting required. The setting not only does not do so, but it strongly tends the other way. In the first place, as we have seen, it is probable that the words "rights to property" in § 3692 were used to describe choses in action in contrast with "property" which stood for chattels, and it is certain that whatever meaning they have in § 3692, they have in § 3710(a). More significantly, so to construe them would introduce an inharmonious exception into the whole scheme of the statute. If the United States can sue a taxpayer's debtor whenever he refuses to pay the collector, § 3710(a) changed the proceeding pro tanto from a sale under a distress to a garnishment; the United States was substituted for the taxpayer as promisee. Even that would not be conclusive, if the intent were plain, or if the interpretation were necessary to give any effect to the change. It is not; on the contrary in what is probably its chief application, i. e. to chattels, § 3710(a) accords with a distress and is ancillary to it; as we have seen, it serves to reduce the taxpayer's goods to the collector's possession so that he can make delivery. And also, in so far as it expressly touches choses in

action at all (assuming that "rights to property" does touch them), it can have no other function. True, a disputed chose in action will not bring as good a price as an undisputed one; but neither will a chattel delivered at a sale if the title is doubtful. Yet certainly the section gives no evidence of any purpose to allow the United States to mend in the district court all infirmities of title in the taxpayer's property. The diction, the setting and the purpose of the section unite to deny the plaintiff's interpretation of the word "property."

The cases on which the plaintiff relies do not stand in the way of this conclusion. In *Cannon v. Nicholas*, 10 Cir., 80 F.2d 934, and *Kyle v. McGuirk*, 3 Cir., 82 F.2d 212, the taxpayer moved to dissolve the warrant of distraint and the court considered the merits of the claim. Possibly it need not have done so on the ground that the collector was entitled to sell out whatever rights the taxpayer had; but certainly it was permissible to consider whether any rights whatever would pass upon the sale, and the point before us was not raised. In *United States v. Long Island Drug Company*, 2 Cir., 115 F.2d 983, the only question which we considered was whether the levy could reach future earnings; again the point was apparently not raised. The same was true in *Commonwealth Bank v. United States*, 6 Cir., 115 F.2d 327. On the other hand the First Circuit, though by a course of reasoning different from ours, held that in the same situation the insurer was not in "possession" of any property belonging to the taxpayer. *United States v. Massachusetts Mut. Life Ins. Co.*, 1 Cir., 127 F.2d 880. Judge Hincks held the same in *United States v. Aetna Life Insurance Co.*, D.C., January, 1942, 46 F.Supp. 30. The other decisions cited did not discuss the question.

Judgment affirmed.

Notes

(A) See Pyle, "Liability of Life Insurance and Annuities for Unpaid Income Taxes of Living Insureds, Annuitants and Beneficiaries," 9 Tax L.Rev. 205 (1954); "Distraint on a Delinquent Taxpayer's Life Insurance Policy from the Insurers," 52 Yale L.J. 928 (1943).

(B) The powers of the collector to distrain and sell both real and personal property under 6331–6344 of the 1954 Code are very broad. See Brewster, Distraint under the Federal Revenue Laws (1937).

(C) *Compromise of Tax Cases.* Section 7122 of the 1954 Code grants broad power to compromise tax cases. The authority of the Treasury Department is, however, restricted. The Attorney General has ruled: "I conclude that where liability has been established by a valid judgment or is certain, and there is no doubt as to the ability of the Government to collect, there is no room for 'mutual concessions,' and therefore no basis for a 'compromise.'" See Op.A.G. 6, 7, XIII–2 C.B. 442, 445 (1934). Full

control over cases in court is vested in the Attorney General under Executive Order 6166, of June 10, 1933. With respect to such suits the Attorney General's power to compromise is inherent and plenary. See Op.A.G. 7, *supra*, and Op.A.G. 8, XIV–1 C.B. 442 (1935). This is now expressly stated in sec. 7122(a) of the 1954 Code.

See Clark, "Tax Compromises in the Department of Justice," 18 Taxes 280 (1940); Paul, "Federal Tax Compromises and Prospective Regulations" in Selected Studies in Federal Taxation 53 (1938).

NELSON v. UNITED STATES

United States Circuit Court of Appeals, Ninth Circuit, 1943. 139 F.2d 162.

GARRECHT, CIRCUIT JUDGE. The appellants Nelson are indebted to the United States for income taxes for the years 1933 and 1934. From 1932 to 1937, appellant George Nelson and partners had a garbage disposal contract with the City of Seattle. During the years 1937 and 1938, appellants Nelson made payments on account of income taxes of from $200 to $250 monthly. On September 20, 1937, the Collector of Internal Revenue received from the Commissioner of Internal Revenue the assessment list containing assessments against George and Agnes Nelson for the 1933 and 1934 taxes. After the above installment payments had been made and credited there was due and owing $667.03 from George Nelson and $1,173.75 from Agnes Nelson, plus interest. In 1938, over Nelson's protest, a receiver was appointed for the partnership; thereafter Nelson advised the Collector of Internal Revenue that it was impossible for him to make further payments. After refusal to pay on demand, the Collector of Internal Revenue issued Warrants of Distraint on November 2, 1937.

On July 29, 1938, and April 21, 1939, the Collector filed notices of tax liens with the auditors of King County and Yakima County, respectively. Notices of tax liens were filed with Clerk of the United States District Court at Tacoma and Spokane, Washington. On December 13, 1938, Nelson gave an order assigning to the Collector all title and interest to the properties in the Receiver's possession. A suit in the State court in King County against the Receiver netted the Government $1,334.06.

During 1940, the appellant taxpayers raised a crop of grapes on the farm located in Yakima County. By contract dated August 19, 1940, the grapes were sold to the National Wine Company. Upon this contract there was due and owing appellants Nelson $2,999.49.

On October 14, 1940, George Nelson assigned to Ollie Halpin his claim against the Wine Company for the purchase price of the 1940 crop. The consideration for the said assignment was a pre-existing debt. The assignment was accepted by the Wine

Company on the same date. On October 25, 1940, the Collector caused to be served on the Wine Company notices of levy and notices of tax lien. These notices were not complied with, so on January 14, 1941 the Wine Company was served with final notice and demand. The present action was then commenced by the appellee against the Wine Company under Section 3710, Title 26 U.S.C.A. Int.Rev.Code, which corporation by motion asked that the taxpayers Nelson and their assignee Halpin be interpleaded as additional defendants.

The lower court held that the lien acquired by the United States was prior in right and in time to the claim of said additional defendant, now one of the appellants, Ollie Halpin. The lower court found the validity of the assignment was not in issue. The appeal from this decision is taken by the appellants Nelson and Halpin. The National Wine Company does not join in the appeal.

Section 3670 provides:

"§ 3670. Property subject to lien.

"If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States *upon all property and rights to property, whether real or personal,* belonging to such person. 53 Stat. 448." [Emphasis added]

Section 3710 provides: "§ 3710. * * * (a) Requirement. Any person in possession of property, or rights to property, subject to distraint, upon which a levy has been made, shall, upon demand by the collector or deputy collector making such levy, surrender such property or rights to such collector or deputy, unless such property or right is, at the time of such demand, subject to an attachment or execution under any judicial process."

The lower court found that the assignment to Halpin was executed on the 14th day of October, 1940, and was served on and accepted by the National Wine Company on the same date, which was subsequent to the filing of the notice of tax liens by the Government. The tax liens notice was filed in Yakima County on April 21, 1939 and with the Clerks of the United States District Courts of Washington at Tacoma and Spokane, August 1, 1938 and April 22, 1939, respectively.

The 1940 grape crop was grown on the farm in Yakima County where the notice of the lien was filed. When severed the Government obtained a prior lien on those grapes as after acquired property. That the Government's lien under this statute applies to after acquired property has already been settled by this Court in *Citizens National Trust & Savings Bank of Los Angeles v. United States,* 9 Cir., 135 F.2d 527, 528. In this case, the tax-

payer inherited an interest in an estate after the liens for taxes had been filed. The lower court concluded that the United States acquired a prior lien upon all property belonging to the taxpayer as of the date the Collector received the assessment list, that said liens had continued in force until the present time, and that the liens attached to all property and rights to property to be acquired by the taxpayer:

Our court said: "The statute provides that the United States shall have a lien 'upon all property' belonging to the taxpayer. There is no limitation placed on the expression in the statute 'the amount * * * shall be a lien * * * upon *all* property and rights to property.' That this expression is not limited to property possessed by the debtor at the time the distraint is laid is plainly indicated by the provision of the statute that the lien 'shall continue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time,' * * *. The claimed liens in this case are upon personal property, but that fact does not change the situation as the section expressly extends to 'all property and rights to property, whether real or personal.'"

Citizens National Trust & Savings Bank of Los Angeles v. United States, supra, quotes extensively from some administrative interpretations of the Revenue Act which provide in short that the lien shall continue until the tax is satisfied and when necessary the Collector should secure an extension of time for collection "whenever it is reasonably possible that the taxpayer may, in the future, acquire property or property rights from which the tax liability may be satisfied."

United States v. Long Island Drug Co., 2 Cir., 115 F.2d 983, which is cited by the appellants and which appears to be contrary to the ruling of the lower court, is distinguished by the *Citizens National Trust & Savings Bank* case on the ground that the problem of the government's lien on after acquired property was not directly in issue.

Under the authority of the latter case, the decision of the lower court is affirmed.

Notes

(A) In *Detroit Bank v. United States,* 317 U.S. 329 (1943), the Court held that the lien for estate tax now found in sec. 6324(a) of the 1954 Code took priority over the lien of a mortgagee who acquired his mortgage for value in good faith without knowledge of the tax lien, even though the lien was not recorded under the provisions of Rev.Stat. 3186. In *Glass City Bank v. United States,* 326 U.S. 265 (1945), the Court held that the lien for income taxes under the provisions now found in secs. 6321 and 6322 of the 1954 Code applies to after acquired property, and that the Government's claim to such property took priority over a judgment creditor who attached the property on execution.

In *United States v. Gilbert Associates, Inc.*, 345 U.S. 361 (1953), it was held that the lien of the United States for taxes took priority over the lien of a town for local property taxes even though the assessment of the town's taxes was, under local law "in the nature of a judgment." The exception for judgments under the provision now found in sec. 6323(a) of the 1954 Code was held to apply only to the "judgment of a court of record."

(B) Where there is (1) an attachment in state proceedings, then (2) a federal tax lien, and finally (3) a judgment in the state proceedings, the federal tax lien takes priority. *United States v. Security Trust Co.*, 340 U.S. 47 (1950); *United States v. Acri*, 348 U.S. 211 (1955). Similarly the tax lien takes priority over an earlier garnishment. *United States v. Liverpool & London & Globe Ins. Co.*, 348 U.S. 215 (1955). See also *United States v. Scovil*, 348 U.S. 218 (1955) (distress for rent).

(C) For discussions of the problems, which are difficult, and serious, see Wolson, "Federal Tax Liens—A Study in Confusion and Confiscation," 43 Marquette L.Rev. 180 (1959); Reiling, "Priority of Federal Tax Liens," 36 Taxes 978 (1958); Plumb, "Federal Tax Collection and Lien Problems," 13 Tax L.Rev. 247, 459 (1958); Cross, "Federal Tax Claims: Nature and Effect of the Government's Weapons for Collection," 27 Fordham L.Rev. 1 (1958).[1]

(D) In *Matter of Rosenberg*, 269 N.Y. 247, 199 N.E. 206 (1935), cert. den. 298 U.S. 669 (1936), the court held that the interest of the beneficiary of a New York trust was subject to a lien for federal taxes, despite the provisions of the New York law making such an interest inalienable. The fact that such an interest is not within the distraint provisions of what is now sec. 6331 of the 1954 Code was not regarded as limiting the lien granted by the present sec. 6321, on "all property and rights to property." See also *United States v. Dallas Nat. Bank*, 152 F.2d 582 (C.C.A.5th, 1945); *Matter of Ryan*, 294 N.Y. 85, 60 N.E.2d 817 (1945).

Life insurance policies. Similarly, it has been held that the Government's lien applies against a life insurance policy, and despite local exemption statutes, when an income tax assessment is made before the death of the insured-taxpayer. *United States v. Behrens*, 230 F.2d 504 (C.A.2d, 1955), certiorari denied, 351 U.S. 919 (1956).

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1 For early treatments of the problem, see Kennedy, "The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien," 63 Yale L.J. 905 (1954); Anderson, "Federal Tax Liens—Their Nature and Priority," 41 Calif.L.Rev. 241 (1953); Wright, "Title Examination as Affected by the Federal Gift and Estate Tax Liens," 51 Mich.L.Rev. 325 (1953); "Removal of Federal Income Tax Lien as Affected by Power of Sale in Mortgage," 49 Yale L.J. 1106 (1940). See also Kohlmeter, "Federal Tax Liens Under Revised Statutes—Section 3186," 13 Tax Mag. 191 (1935); Rogge, "The Tax Lien of the United States," 13 A.B.A.J. 576 (1927).

COMMISSIONER v. STERN

Supreme Court of the United States, 1958. 357 U.S. 39.

MR. JUSTICE BRENNAN delivered the opinion of the Court.

Respondent petitioned the Tax Court for redetermination of the liability assessed against her for her deceased husband's unpaid income tax deficiencies. The Tax Court held that, as beneficiary of proceeds of her husband's life insurance exceeding the amount of the deficiencies, the respondent was liable for the full amount of the deficiencies. The Court of Appeals reversed, 242 F.2d 322, holding that the respondent was not liable even to the extent of the amount of the cash surrender values of the policies, which was less than the amount of the deficiencies. We granted certiorari. 355 U.S. 810.

Dr. Milton J. Stern died a resident of Lexington, Kentucky, on June 12, 1949. Nearly six years later the Tax Court held that Dr. Stern had been deficient in his income taxes for the years 1944 through 1947 and was liable for the amount, including interest and penalties, of $32,777.51. Because the assets of the estate were insufficient to meet this liability, the Commissioner proceeded under § 311 of the Internal Revenue Code of 1939 [1] against respondent, Dr. Stern's widow, as the beneficiary of life insurance policies held by him. The proceeds and the cash surrender value of these policies at Dr. Stern's death totaled $47,282.02 and $27,259.68 respectively. The right to change the beneficiary and to draw down the cash surrender value of each policy had been retained until death by Dr. Stern. There were no findings that Dr. Stern paid any premiums with intent to defraud his creditors or that he was insolvent at any time prior to his death.

The Court of Appeals rested its decision upon two grounds: (1) that the respondent beneficiary was not a transferee within the meaning of § 311, *Tyson v. Commissioner*, 212 F.2d 16; and (2) that in any event Kentucky statutes, Ky.R.S. §§ 297.140,

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1 Section 311 provides:

"(a) Method of collection. The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

"(1) Transferees. The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

. . . .

"(f) Definition of 'transferee.' As used in this section, the term 'transferee' includes heir, legatee, devisee, and distributee."

297.150, limit the beneficiary's liability to creditors of the deceased insured to the amount of the premiums paid by the insured in fraud of creditors, and consequently there was no liability since there was no evidence that Dr. Stern paid any premium in fraud of his creditors. Without intimating any view as to the correctness of the first holding of the Court of Appeals we find it unnecessary to decide whether the respondent was a transferee within the meaning of § 311 [2] because we hold that the Kentucky statutes govern the question of the beneficiary's liability and create no liability of the respondent to the Government in the circumstances of this case.

First. Section 311(a) provides that "The liability at law or in equity, of a transferee of property of a taxpayer, in respect of the tax . . . imposed upon the taxpayer by this chapter" shall be "assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter . . . ." The decisions of the Court of Appeals and the Tax Court have been in conflict on the question whether the substantive liability enforced under § 311 is to be determined by state or federal law. Compare, *e. g., Rowen v. Commissioner,* 215 F.2d 641, and *Botz v. Helvering,* 134 F.2d 538, with *United States v. Bess,* 243 F.2d 675, and *Stoumen v. Commissioner,* 27 T.C. 1014. This Court has expressly left the question open. *Phillips v. Commissioner,* 283 U.S. 589, 602.

The courts have repeatedly recognized that § 311 neither creates nor defines a substantive liability but provides merely a new procedure by which the Government may collect taxes. *Phillips v. Commissioner, supra; Hatch v. Morosco Holding Co.,* 50 F.2d 138; *Liquidators of Exchange National Bank v. United States,* 65 F.2d 316; *Harwood v. Eaton,* 68 F.2d 12; *Weil v. Commissioner,* 91 F.2d 944; *Tooley v. Commissioner,* 121 F.2d 350.[3] Prior to the enactment of § 280 of the Revenue Act of 1926, the predeces-

2 The Court of Appeals in this case followed its own prior decision in Tyson v. Commissioner, 212 F.2d 16, in holding that Mrs. Stern as beneficiary was not a "transferee" of any part of the proceeds within the meaning of § 311. Other Courts of Appeals have held that the beneficiary is a transferee only to the extent of the cash surrender value existing at the time of the insured's death. Rowen v. Commissioner, 215 F.2d 641; United States v. Bess, 243 F.2d 675. The Tax Court, on the other hand, has held that the beneficiary is the transferee of the entire proceeds. Stoumen v. Commissioner, 27 T.C. 1014.

3 The Government argues that since § 311 and § 900 were originally enacted as correlative provisions of the Revenue Act of 1926 a substantive liability is imposed upon the beneficiary for both unpaid income and estate taxes of the decedent. But the 1939 Code "contains no provision in respect to income tax collection comparable to Section 827(b) of the Code which expressly imposes liability for the estate tax on a 'beneficiary, who receives . . . property included in the gross estate under section [811(b)].'" Rowen v. Commissioner, 215 F.2d 641, 646.

sor of § 311, the rights of the Government as creditor, enforceable only by bringing a bill in equity or an action at law, depended upon state statutes or legal theories developed by the courts for the protection of private creditors, as in cases where the debtor had transferred his property to another. *Phillips v. Commissioner, supra*, at 592, n. 2; cf. *Pierce v. United States,* 255 U.S. 398; *Hospes v. Northwestern Mfg. & Car Co.,* 48 Minn. 174, 50 N.W. 1117. This procedure proved unduly cumbersome, however, in comparison with the summary administrative remedy allowed against the taxpayer himself, Rev.Stat. § 3187, as amended by the Revenue Act of 1924, 43 Stat. 343. The predecessor section of § 311 was designed "to provide for the enforcement of such liability to the Government by the procedure provided in the act for the enforcement of tax deficiencies." S.Rep.No.52, 69th Cong., 1st Sess. 30. "Without in any way changing the extent of such liability of the transferee under existing law, . . . [this section] enforces such liability . . . in the same manner as liability for a tax deficiency is enforced; that is, notice by the commissioner to the transferee and opportunity either to pay and sue for refund or else to proceed before the Board of Tax Appeals, with review by the courts. Such a proceeding is in lieu of the present equity proceeding . . . ." H.R.Rep.No.356, 69th Cong., 1st Sess. 43–44. Therefore, since § 311 is purely a procedural statute we must look to other sources for definition of the substantive liability. Since no federal statute defines such liability, we are left with a choice between federal decisional law and state law for its definition.

Second. The Government urges that, to further "uniformity of liability," we reject the applicability of Kentucky law in favor of having the federal courts fashion governing rules. Cf. *Clearfield Trust Co.* v. *United States,* 318 U.S. 363. But a federal decisional law in this field displacing state statutes as determinative of liability would be a sharp break with the past. Federal courts, in cases where the Government seeks to collect unpaid taxes from persons other than the defaulting taxpayer, have applied state statutes, *Hutton v. Commissioner,* 59 F.2d 66; *Weil v. Commissioner, supra; United States v. Goldblatt,* 128 F.2d 576; *Botz v. Helvering, supra,* and the Government itself has urged reliance upon such statutes in similar cases, G.C.M. 2514, VI–2 Cum.Bull. 99; G.C.M. 3491, VII–1 Cum.Bull. 147. The Congress was aware of the use of state statutes when the enactment of the predecessor section to § 311 was under consideration, for the Congress in disclaiming any intention "to define or change existing liability," S.Rep.No.52, 69th Cong., 1st Sess. 30, identified "existing liability" as liability ensuing "[b]y reason of the trust fund doctrine and various State statutory provisions . . . ." H.R.Rep.No.356, *supra,* at 43.

It is true that, in addition to reliance upon state statutes, the Government invoked principles judicially developed for the protection of private creditors, in cases where the debtor had transferred his property to another and been left insolvent. Cf. *Pierce v. United States, supra; Hospes v. Northwestern Mfg. & Car Co., supra.* In such cases the federal courts applied a "general law" which did not distinguish between federal and state decisional law. But the fact remains that the varying definitions of liability under state statutes resulted in an absence of uniformity of liability. Yet Congress, with knowledge that this was "existing law" at the time the predecessor section to § 311 was enacted, has refrained from disturbing the prevailing practice. Uniformity is not always the federal policy. Under § 70 of the Bankruptcy Act, for instance, state law is applied to determine what property of the bankrupt has been transferred in fraud of creditors. 30 Stat. 565, as amended, 11 U.S.C. § 110. What is a good transfer in one jurisdiction might not be so in another.

Since Congress has not manifested a desire for uniformity of liability, we think that the creation of a federal decisional law would be inappropriate in these cases. In diversity cases, the federal courts must now apply state decisional law in defining state-created rights, obligations, and liabilities. *Erie R. Co. v. Tompkins,* 304 U.S. 64. They would, of course, do so in diversity actions brought by private creditors. Since the federal courts no longer formulate a body of federal decisional law for the larger field of creditor's rights in diversity cases, any such effort for the small field of actions by the Government as a creditor would be necessarily episodic. That effort is plainly not justified when there exists a flexible body of pertinent state law continuously being adapted to changing circumstances affecting all creditors. Accordingly we hold that, until Congress speaks to the contrary, the existence and extent of liability should be determined by state law.

Third. The Court of Appeals held in this case that under the applicable Kentucky law the beneficiary of a life insurance policy is not liable to the insured's creditors, at least where, as here, the premiums have not been paid in fraud of creditors. Ky.R.S. §§ 297.140, 297.150,[4] and that therefore no liability of the re-

[4] Kentucky Revised Statutes provide:

"297.140 *Life insurance for benefit of a married woman; premiums paid in fraud of creditors.*—(1) A policy of insurance on the life of any person expressed to be for the benefit of, or duly assigned, transferred or made payable to, any married woman, or to any person in trust for her, or for her benefit, by whomsoever such transfer may be made, shall inure to her separate use and benefit and that of her children, independently of her husband or his creditors or any other person effecting or transferring the policy or his creditors.

"(2) A married woman may, without consent of her husband, contract, pay for, take out and hold a policy of insurance upon the life or health of her

spondent exists under state law to any creditor, including the Government. The parties do not contest this construction of local law.

The Government, however, argues in its brief, "Just as in the situation where a tax lien has attached it is held that state law may not destroy that lien, so here, where a tax liability is imposed by Congress, the state may not provide exemptions." We agree that state law may not destroy a tax lien which has attached in the insured's lifetime. We held today in *United States v. Bess,* 357 U.S. 51, that a New Jersey statute, similar to the Kentucky statutes, could not defeat the attachment in the insured's lifetime of a federal tax lien under § 3670 against the cash surrender value of the policy, or prevent enforcement of the lien out of the proceeds received by the beneficiary on the insured's death. We might also agree that a State may not provide exemptions from a tax liability imposed by Congress. The fallacy in the Government's argument is in the premise that Congress has imposed a tax liability against the beneficiary. We have concluded that Congress has not seen fit to define that liability and that none exists except such as is imposed by state law. Thus there is no problem here of giving effect to state exemption provisions when federal law imposes such liability. The Government's rights in this case are precisely those which other creditors would have under Kentucky law. The respondent is not liable to the Government because Kentucky law imposes no liability against respondent in favor of Dr. Stern's other creditors.

Affirmed.

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husband or children, or against loss by his or their disablement by accident. The premiums paid on the policy shall be held to have been her separate estate, and the policy shall inure to her separate use and benefit and that of her children, free from any claim of her husband or others.

"(3) If the premium on any policy mentioned in this section is paid by any person with intent to defraud his creditors, an amount equal to the premium so paid, with interest thereon, shall inure to the benefit of the creditors, subject to the statute of limitations.

"297.150 *Life insurance for the benefit of another; premiums paid in fraud of creditors.*—(1) When a policy of insurance is effected by any person on his own life or on another life in favor of some person other than himself having an insurable interest therein, the lawful beneficiary thereof, other than the person effecting the insurance or his legal representatives, shall be entitled to its proceeds against the creditors and representatives of the person effecting the same.

"(2) Subject to the statute of limitations, the amount of any premiums for such insurance paid in fraud of creditors, with interest thereon, shall inure to their benefit from the proceeds of the policy, but the company issuing the policy shall be discharged of all liability thereon by payment of its proceeds in accordance with its terms, unless, before such payment, the company received written notice by or in behalf of some creditor, with specification of the amount claimed, claiming to recover for certain premiums paid in fraud of creditors."

MR. JUSTICE BLACK, whom THE CHIEF JUSTICE and MR. JUSTICE WHITTAKER join, dissenting.

We are concerned here with a suit against the United States to determine the liability of a party for federal income taxes. In my judgment it is a mistake to look to state law to decide that liability. The laws of the several States are bound to vary widely with respect to the responsibility of transferees for the obligations of their transferors. Therefore application of state law leads to the anomalous result that transferees will be liable for federal taxes in one State but not in another even though they stand in precisely the same position. I believe that such uneven application of what this Court has characterized as "a nation-wide scheme of taxation," *Burnet v. Harmel,* 287 U.S. 103, 110, is thoroughly unwise and is not required by the Constitution, by Act of Congress, or by any compelling practical considerations.

In my view, liability for federal taxes should be determined by uniform principles of federal law, in the absence of the plainest congressional mandate to the contrary.* Where as here Congress has provided no standards which define the liability of a transferee for the taxes of his transferor the federal courts themselves should fashion a uniform body of controlling rules which fairly implement the collection of government revenues. Cf. *Clearfield Trust Co. v. United States,* 318 U.S. 363; *United States v. Standard Rice Co.,* 323 U.S. 106; *United States v. Standard Oil Co.,* 332 U.S. 301; *Priebe & Sons, Inc., v. United States,* 332 U.S. 407; *Textile Workers Union of America v. Lincoln Mills of Alabama,* 353 U.S. 448. . . .

I would hold, as a matter of federal law, that where a transferee receives property from a taxpayer who is left with insufficient assets to pay his federal taxes the transferee is liable for those taxes to the extent he has not given fair consideration for the property received. This has been the rule applied by those courts which have heretofore determined transferee liability on the basis of federal law. See, *e. g., Pearlman v. Commissioner,* 153 F.2d 560; *Updike v. United States,* 8 F.2d 913; *Stoumen v. Commissioner,* 27 T.C. 1014. Such a rule has long-standing antecedents in the federal courts which may be traced back, in part,

* "[A]s we have often had occasion to point out, the revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to state control or limitation unless the language or necessary implication of the section involved makes its application dependent on state law." United States v. Pelzer, 312 U.S. 399, 402–403.

Of course state law must be consulted to determine what property rights and interests a taxpayer actually has. But once these rights and interests are thus established, their consequence for purposes of federal taxation is a matter of federal law. Watson v. Commissioner, 345 U.S. 544; Morgan v. Commissioner, 309 U.S. 78; Burnet v. Harmel, 287 U.S. 103.

at least as far as the noted decision by Justice Story in *Wood v. Drummer*, 30 Fed.Cas. 435. It would operate to prevent tax evasion, and yet not impose an unfair burden on transferees.

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Notes

(A) As appears in the closing paragraphs of both opinions, the Court at the same time decided *United States v. Bess*, 357 U.S. 51 (1958). In that case it was held that a federal tax *lien* did attach to the cash surrender value of an insurance policy at the time of death, and might be enforced against the proceeds in the hands of the beneficiary, up to the amount of the cash surrender value.

There are comments on the *Stern* and *Bess* cases in 44 Cornell L.Q. 278 (1959); 8 De Paul L.Rev. 131 (1958); 57 Mich.L.Rev. 285 (1958); 107 U. of Pa.L.Rev. 290 (1958); and 31 Rocky Mt. L.Rev. 108 (1958). See also Barton, "What the Supreme Court Said About Stern and Bess," 37 Taxes 9 (1959); Barton, "What the Supreme Court Said About Transferee Liability," 1959 Ins. L.J. 73; and Heron, "Federal Tax Claims Again, or Devastation Revisited," 26 Ins.Counsel J. 112 (1959). For earlier discussions of the problems, see Grayck, "Income Tax Transferee Liability of a Life Insurance Beneficiary," 13 Tax L.Rev. 313 (1958); Williams and Baer, "Life Insurance Proceeds and Transferee Liability for Income Taxes," 36 Taxes 89 (1958).

(B) The insurance company is not liable as a transferee of property from the taxpayer. *John Hancock Mutual Life Ins. Co. v. Helvering*, 128 F.2d 745 (U.S.App.D.C.1942); *Equitable Life Ins. Society*, 19 T.C. 264 (1952).

(C) The constitutionality of the transferee provisions was sustained in *Phillips v. Commissioner*, 283 U.S. 589 (1931). Transferee liability for income, estate and gift taxes is now governed by sec. 6901(a)(1) of the 1954 Code.[1]

See also sec. 3467 of the Revised Statutes, as amended by sec. 518(a) of the Revenue Act of 1934 (U.S.C., Title 31, sec. 192), imposing liability on fiduciaries who distribute the assets in their possession without first paying debts due the United States.[2] See Oelbaum, "Directors' Liability for Federal Taxes as a Result of Corporate Liquidation," 34 Taxes 477 (1956).

Where several persons are liable as transferees, and a disproportionate part of the tax is collected from one of them, he is entitled to contribution from the others. *Phillips-Jones Corp. v. Parmley*, 302 U.S. 233 (1937).

(D) In *Vendig v. Commissioner*, 229 F.2d 93 (C.A.2d, 1956), the situation was as follows: T owned preferred stock in the A Corporation. All of the rest of the stock of A was owned by B Corporation. T transferred her stock in A to B and received in exchange therefor preferred stock in B. Thereafter, A was

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1 See Kamens and Ancier, "Elements of Transferee Liability," 32 Taxes 509 (1954); Bennett, "An Analysis of Transferee Liability," 30 Taxes 806 (1952).

2 See Alexander, "Personal Liability of Executors and Trustees for Federal Income, Estate and Gift Taxes," 9 Tax L.Rev. 1 (1953).

dissolved and B received all of its assets. Later, it developed that A had income tax deficiencies. The Commissioner then proceeded against T as a transferee to collect on account of A's income tax liability.

The court, reversing the Tax Court, held that T was not a "transferee" of A. She never did receive, directly or indirectly, any property belonging to A. In reaching its result, the Court distinguished and disapproved an apparently contrary decision in *Bates Motor Transportation Lines, Inc. v. Commissioner,* 200 F.2d 20 (C.A.7th, 1952).

(E) The transferee is liable not only for the tax, but also for interest on the tax. It is now established that the transferee may deduct from his income the interest which he has to pay at least from the date of the transfer of the property to him. It has been so held in *Koppers Co.,* 3 T.C. 62 (1943), and in *Commissioner v. Breyer,* 151 F.2d 267 (C.C.A.3d, 1945). And in 1946–1 Cum.Bull. 3, the Commissioner announced his acquiescence in the *Koppers* decision. See also *Commissioner v. Collins,* 153 F.2d 1022 (C.A.9th, 1946).

(F) In *Commissioner v. Western Union Tel. Co.,* 141 F.2d 774 (C.C.A.2d, 1944), noted in 57 Harv.L.Rev. 1116 (1944), corporation A had leased all its property to corporation B, and the latter agreed to pay as rent a percentage of A's stock direct to A's stockholders. A tax was assessed against A, but was uncollectible as A had no assets except the leased property. It was held that the stockholders of A were liable as transferees. *Bosworth v. Commissioner,* 194 F.2d 102 (C.A.2d, 1952), *accord.*

(G) Under sec. 6901(c) of the 1954 Code, the limitations period against transferees is one year after the expiration of the period against the transferor. This has the effect of providing a four year period for the collection of any gift tax despite the basic statutory period of three years, since the trustee and the donees are always transferees. See "The Statute of Limitations in Gift Tax Cases," 57 Harv.L.Rev. 906 (1944).

If the transferee is a widow who received the property from her husband and who filed a joint return with him in the year of the deficiency concerned, she is directly liable as taxpayer. This has been held to be the controlling liability for purposes of the period of limitations, so that an action cannot be brought against her as transferee after the expiration of the three year period. *Floersch v. United States,* 171 F.Supp. 260 (D.N.M.1959).

D. PENALTIES AND CRIMINAL PROSECUTION

Secs. 6651–6659, 7201–7214 of the 1954 Code

HELVERING v. MITCHELL

Supreme Court of the United States, 1938. 303 U.S. 391.

MR. JUSTICE BRANDEIS delivered the opinion of the Court.

Revenue Act of 1928, c. 852, Sec. 293, 45 Stat. 791, provides, in dealing with assessment of deficiencies in income tax returns:

"(b) *Fraud.*—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected and paid. . . . "

The question for decision is whether assessment of the addition is barred by the acquittal of the defendant on an indictment under Section 146(b) of the same Act for a willful attempt to evade and defeat the tax.

The Commissioner of Internal Revenue found that Charles E. Mitchell of New York had, in his income tax return for the year 1929, fraudulently deducted from admitted gross income an alleged loss of $2,872,305.50 from a purported sale of 18,300 shares of National City Bank stock to his wife; that he had fraudulently failed to return the sum of $666,666.67 received by him as a distribution from the management fund of the National City Company, of which he was chairman; and that these fraudulent acts were done with intent to evade the tax. On December 8, 1933, the Commissioner notified Mitchell that there was a deficiency in his tax return of $728,709.84 and, on account of the fraud, a 50 per cent. addition thereto in the sum of $364,354.92.

Mitchell appealed to the Board of Tax Appeals, which sustained the Commissioner's determination. 32 B.T.A. 1093. Upon a petition for review, the Circuit Court of Appeals concluded that there was ample evidence to support the Board's findings that Mitchell had fraudulently made deduction of the loss that he had fraudulently failed to return the amount received from the management fund; and that, despite the facts hereafter stated, the Board was free to find the facts according to the evidence. It accordingly affirmed the assessment of the deficiency of $728,709.84. But it reversed the Board's approval of the additional assessment of $364,354.92, because of the following facts:

Before the deficiency assessment was made Mitchell had been indicted in the federal court for southern New York under Section 146(b) of the Revenue Act of 1928, which provides:

"Any person . . . who wilfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than 5 years, or both, together with the costs of prosecution."

The first count charged that Mitchell "unlawfully, wilfully, knowingly, feloniously, and fraudulently did attempt to defeat and evade an income tax of, to wit, $728,709.84, upon his net income for 1929." He was tried on the indictment and acquitted

on all the counts. The item of $728,709.84 set out in the first count is the same item as that involved in the deficiency assessed; and both arose from the same transactions of Mitchell. But the addition of $364,354.92 by reason of fraud was not involved in the indictment.

The Circuit Court of Appeals held that the prior judgment of acquittal was not a bar under the doctrine of *res judicata;* and hence it affirmed the assessment of the $728,709.84. But it held that our decisions in *Coffey v. United States*, 116 U.S. 436, and *United States v. La Franca,* 282 U.S. 568, required it "to treat the imposition of the penalty of 50 percent as barred by the prior acquittal of Mitchell in the criminal action." 89 F.2d 873. Mitchell's petition for certiorari to review so much of the judgment as upheld the assessment of the deficiency of $728,709.84 was denied. The Commissioner's petition to review so much of the judgment as denied the 50 per centum in addition was granted, because of the importance in the administration of the revenue laws of the questions presented and alleged conflict in decisions.

First. Mitchell contends that the claim for the 50 percent is barred by the doctrine of *res judicata.* He asserts that all the facts and intents requisite to the imposition of the 50 per centum addition to the deficiency were put in issue and determined against the Government in the criminal trial, and that hence, under the doctrine of *res judicata* the judgment of acquittal bars it from obtaining a second judgment based upon the same facts and intents. Since this proceeding to determine whether the amount claimed is payable as a tax is a proceeding different in its nature from the indictment for the crime of wilfully attempting to evade the tax, the contention that the doctrine of estoppel by judgment applies rests wholly on the assertion that the issues here presented were litigated and determined in the criminal proceeding. Compare *Tait v. Western Maryland Ry.,* 289 U.S. 620, 623. But this is not true.

The difference in degree of the burden of proof in criminal and civil cases precludes application of the doctrine of *res judicata.* The acquittal was "merely . . . an adjudication that the proof was not sufficient to overcome all reasonable doubt of the guilt of the accused." *Lewis v. Frick,* 233 U.S. 291, 302. It did not determine that Mitchell had not wilfully attempted to evade the tax. That acquittal on a criminal charge is not a bar to a civil action by the Government, remedial in its nature, arising out of the same facts on which the criminal proceeding was based has long been settled. *Stone v. United States,* 167 U.S. 178, 188; *Murphy v. United States,* 272 U.S. 630, 631, 632.

Compare *Chantang Co. v. Abaroa,* 218 U.S. 476, 481, 482.[1] Where the objective of the subsequent action likewise is punishment, the acquittal is a bar, because to entertain the second proceeding for punishment would subject the defendant to double jeopardy; and double jeopardy is precluded by the Fifth Amendment whether the verdict was an acquittal or a conviction. *Murphy v. United States,* 272 U.S. 630, 632. . . .

Second. Mitchell contends that this proceeding is barred under the doctrine of double jeopardy because the 50 per centum addition of $364,354.92 is not a tax, but a criminal penalty intended as punishment for allegedly fraudulent acts. Unless this sanction was intended as punishment, so that the proceeding is essentially criminal, the double jeopardy clause provided for the defendant in criminal prosecutions is not applicable.

1. In assessing income taxes the Government relies primarily upon the disclosure by the taxpayer of the relevant facts. This disclosure it requires him to make in his annual return. To insure full and honest disclosure, to discourage fraudulent attempts to evade the tax, Congress imposes sanctions. Such sanctions may confessedly be either criminal or civil . . . The question for decision is thus whether Section 293(b) imposes a criminal sanction. That question is one of statutory construction. Compare *Murphy v. United States,* 272 U.S. 630, 632.

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2. The remedial character of sanctions imposing additions to a tax has been made clear by this Court in passing upon similar legislation. They are provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud.[2] In *Stockwell v. United States,* 13 Wall. 531, 537, 551, the Court said of a provision which added double the value of the goods:

"It must therefore be considered as remedial, as providing indemnity for loss. And it is not the less so because the liability of the wrongdoer is measured by double the value of the goods received, concealed, or purchased, instead of the single value. The act of abstracting goods illegally imported, receiving, concealing or buying them, interposes difficulties in the way of a

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[1] United States v. Warner Bros. Pictures, Inc., 13 F.Supp. 614 (E.D.Mo.), affirmed on other grounds, 298 U.S. 643; United States v. Donaldson-Schultz Co., 148 Fed. 581 (C.C.A. 4); United States v. Schneider, 35 Fed. 107 (C.C.D. Ore.); Sanden v. Morgan, 225 Fed. 266, 268–69 (S.D.N.Y.).

[2] Taylor v. United States, 3 How. 197, 210; Bartlett v. Kane, 16 How. 263, 274; Cliquot's Champagne, 3 Wall. 114, 145; Dorsheimer v. United States, 7 Wall. 166, 173; Passavant v. United States, 148 U.S. 214, 221. Compare McDowell v. Heiner, 9 F.2d 120 (W.D.Pa.), affirmed on opinion below, 15 F.2d 1015 (C.C.A. 3); Doll v. Evans, 7 Fed.Cas.No.3,969 (C.C.E.D.Pa.); Stearns v. United States, 22 Fed.Cas.No.13,341, (C.C.)

government seizure, and impairs, therefore, the value of the government right. It is, then, hardly accurate to say that the only loss the government can sustain from concealing the goods liable to seizure is their single value, or to assert that the liability imposed by the statute of double the value is arbitrary and without reference to indemnification. Double the value may not be more than complete indemnity. . . .

"The Act of 1823 was, as we have said, remedial in its nature. Its purpose was to secure full compensation for interference with the rights of the United States. . . ."

3. In Sections 276 and 293 it is provided that collection of the 50 per centum addition, like that of the primary tax itself, may be made "by distraint" as well as "by a proceeding in court." If the section provided a criminal sanction, the provision for collection by distraint would make it unconstitutional.[3] Compare *Lipke v. Lederer*, 259 U.S. 557; *Regal Drug Corp. v. Wardell*, 260 U.S. 386. See also *United States v. Chouteau*, 102 U.S. 603, 611; *Boyd v. United States*, 116 U.S. 616; *Lees v. United States*, 150 U.S. 476; *United States v. La Franca*, 282 U.S. 568. That Congress provided a distinctly civil procedure for the collection of the additional 50 per centum indicates clearly that it intended a civil, not a criminal, sanction. Civil procedure is incompatible with the accepted rules and constitutional guaranties governing the trial of criminal prosecutions, and where civil procedure is prescribed for the enforcement of remedial sanctions, those rules and guaranties do not apply. . . .

4. The fact that the Revenue Act of 1928 contains two separate and distinct provisions imposing sanctions, and that these appear in different parts of the statute, helps to make clear the character of that here invoked. The sanction of fine and imprisonment prescribed by Section 146(b) for willful attempts "in any manner to evade or defeat any [income] tax," introduced into the Act under the heading "Penalties," is obviously a criminal one. The sanction of 50 per centum addition "if any part of any deficiency is due to fraud with intent to evade tax," prescribed by Section 293(b), introduced into the Act under the heading "Additions to the Tax," was clearly intended as a civil one. This sanction, and other additions to the tax are set forth in Supplement M, entitled "Interest and Additions to the Tax."

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[3] Even though Congress may not provide civil procedure for the enforcement of punitive sanctions, nothing in the Constitution prevents the enforcement of distinctly remedial sanctions by a criminal instead of a civil form of proceeding. Compare United States v. Stevenson, 215 U.S. 199, with United States v. Regan, 232 U.S. 37, both enforcing the sanction prescribed in 34 Stat. 898. The fact that a criminal procedure is prescribed for the enforcement of a sanction may be an indication that it is intended to be punitive, but cannot be deemed conclusive if alternative enforcement by a civil proceeding is sustained.

The supplement includes, besides Section 293(b), Sections 291, 292, 293(a) and 294. Section 291 prescribes a 25 per centum addition for failure to make and file a return; Section 292 prescribes interest at the rate of 6 per centum per annum upon the deficiency from the date prescribed for payment of the tax; Section 293(a), an addition of 5 per centum if the deficiency "is due to negligence, or intentional disregard of rules and regulations but without intent to defraud"; and Section 294 prescribes an addition to the tax of 1 per centum per month in case of non-payment. Obviously all of these "Additions to the Tax" were intended by Congress as civil incidents of the assessment and collection of the income tax.[4] . . .

Reversed.

MR. JUSTICE MCREYNOLDS is of the opinion that the judgment of the Circuit Court of Appeals should be affirmed.

Notes

(A) For discussions of problems in fraud cases, see Avakian, "Rights and Remedies of Taxpayers Suspected of Fraud," 33 Taxes 878 (1955); Lipton, "Current Problems in the Tax Fraud Field," 1955 Wis.L.Rev. 416; Lipton, "Trends in Tax Fraud Investigations and Litigation," 34 Taxes 267 (1956); Lipton, "The Taxpayer's Rights in Fraud Cases," 42 A.B.A.J. 325 (1956); "Constitutional Aspects of Federal Tax Investigations," 57 Col.L.Rev. 676 (1957); Greenside, "The Importance of the Original Tax Return in Civil Fraud Cases," 36 Taxes 322 (1958); "The Inquisitorial Powers of the Federal Government in Third Party Tax Investigations," 41 Minn.L.Rev. 800 (1957); Avakian, "Current Developments in Tax Fraud Investigations," 35 Taxes 1005 (1957); Freeman, "The Expanding Concept of Tax Fraud," 45 A.B.A.J. 577 (1959); Van Alstyne and Barton, "Income Tax Litigation: The Arena for Morals," 38 Neb.L.Rev. 692 (1959); Mortenson, Federal Tax Fraud Law (1958), reviewed in 37 Tex.L.Rev. 650 (1959).[1]

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[4] Section 104 imposes a somewhat similar additional tax of 50 per centum of the net income in the case of corporations formed or availed of for the purpose of avoiding surtax on their shareholders through improper accumulation of surplus. Compare United Business Corp. v. Commissioner, 62 F.2d 754 (C.C.A.2d, 1933).

[1] For earlier references, see Tax Fraud Cases—Practice and Procedure (1951), a publication sponsored by the Tax Section of the American Bar Association; Smith, "Policies and Procedure in Income Tax Fraud Cases," 28 Taxes 761 (1950); Griffen, "Fraud," 28 Taxes 151 (1950); Gordon, "Income Tax Penalties," 5 Tax L.Rev. 131 (1950); Spencer, "Proof of Income Tax Fraud," 2 Tax L.Rev. 451 (1947); Rachlin, "Voluntary Disclosures in Tax Fraud and Evasion Cases," 25 Taxes 293 (1947); Platt, "What To Do When Fraud is Alleged in Tax Cases," 85 J. of Accountancy 30 (1948); Foley, "Fraud and Evasion," 24 Taxes 1034 (1946); "Statutory Penalties—A Legal Hybrid," 51 Harv.L.Rev. 1092 (1938).

See also Lourie and Cutler, "Lawyer's Engagement of Accountant in a Federal Tax Fraud Case," 10 Tax L.Rev. 227 (1955); Mehlman, "The Motion for a Sound and Better Statement in Net Worth Fraud Cases," 10 Tax L.Rev. 267 (1955).

(B) Note the provision of sec. 6653(a) of the 1954 Code, imposing a five per cent negligence penalty. See also sec. 6651, imposing a penalty in case of failure to file a return. But note, too, the important fact that relief may be had from the latter penalty if "it is shown that such failure is due to reasonable cause and not due to willful neglect." See Reisner, "Relief from Delinquency Penalties: The Internal Revenue Code," 98 U. of Pa.L. Rev. 183 (1949); Spilky, "Reasonable Cause as an Excuse for Delinquent Filing," 28 Taxes 325 (1950).

(C) Suppose no return is filed on the advice of a lawyer or "tax consultant" that none is required. Is the delinquency excused? Compare *Hermax Co. v. Commissioner,* 175 F.2d 776 (C.A.3d, 1949), with *Haywood Lumber & Mining Co. v. Commissioner,* 178 F.2d 769 (C.A.D.C.1950).

(D) *Contempt.* Section 7602 of the 1954 Code authorizes the Secretary or his delegate to take the testimony of any person, and to require the production of books and records. Section 7604 gives the district courts of the United States jurisdiction to compel attendance, testimony or the production of books. *Cf. Pacific Mills v. Kenefick,* 99 F.2d 188 (C.C.A.1st, 1938), noted in 39 Col. L.Rev. 309 (1939). Failure to obey the court's order is a civil, and not a criminal, contempt. *McCrone v. United States,* 307 U.S. 61 (1939).[2]

The person who is required to testify is, under the Administrative Procedure Act, entitled to have counsel present with him, of his own choosing. *Backer v. Commissioner,* 275 F.2d 141 (C.A. 5th, 1960).

See also Redlich, "Searches, Seizures and Self-Incrimination in Tax Cases," 10 Tax L.Rev. 191 (1955); Lipton, "Privileged Communications," Proc.N.Y.U. 13th Ann.Inst. on Federal Taxation 955 (1954).

KIRK v. COMMISSIONER

United States Court of Appeals, First Circuit, 1950. 179 F.2d 619.

WOODBURY, CIRCUIT JUDGE. This petition for review of a decision of the Tax Court of the United States presents but a single narrow question of law. The facts which raise it can be briefly stated.

The petitioner's decedent, who died on April 5, 1943, filed individual income tax returns with the Collector of Internal Revenue for the district of Massachusetts for the years 1936 to 1942, inclusive, in which it is now conceded that he fraudulently

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2 Willful failure to give information may be the basis of a criminal prosecution under 7203 of the 1954 Code. See United States v. Murdock, 284 U.S. 141 (1931), noted in 16 Minn.L.Rev. 604 (1932), where it was held in such a prosecution that the information sought might incriminate the defendant under state law (as, that the money in question was paid to a state officer as a bribe) was not necessarily a bar.

See also Gutkin and Beck, "Subpoena Powers and the Statute of Limitations in Federal Tax Inquiries and Prosecutions," 8 Rutgers L.Rev. 435 (1954); Gould, "The Taxpayer's Constitutional Privileges in Income Tax Investigations," 31 Dicta 325 (1954).

underestimated his taxable income with intent to evade the tax thereon. The Commissioner discovered the fraud subsequent to the decedent's death, and in consequence determined deficiencies against his estate for the above years, and then, acting pursuant to § 293(b) of the Internal Revenue Code, added 50 per centum to the deficiency for each year. The question presented is whether liability for the 50 per centum additions to deficiencies for fraud which are imposed in identical language by § 293(b) of the Revenue Acts of 1936 and 1938 and of the Internal Revenue Code [2] survives the taxpayer's death, and therefore may be asserted against his estate.

Congress has not enacted any specific provision with respect to survival of the liability for fraud imposed by the above section. Nor, indeed, has Congress enacted any provision with respect to the survival of ordinary tax liability. Under these circumstances both the petitioner and the Commissioner agree that the question of the survival of liability for tax fraud must be resolved by application of general legal rules and principles, and they also both agree that since the liability here involved is imposed by a federal statute, the applicable rules and principles are those developed in the federal courts and not those to be found in the statutes or decisions of any state. . . .

The federal courts over the years have given a great deal of study to the general problem of survival, as the above cases, and the cases cited therein, clearly demonstrate. We see no occasion here to canvass the general problem again or to trace its gradual development. It will suffice for present purposes to say that it was authoritatively established many years ago in *Schreiber v. Sharpless,* [110 U.S. 76], p. 80, that "At common law actions on penal statutes do not survive. . . .", and that "The right to proceed against the representatives of a deceased person depends not on forms and modes of proceeding in a suit, but on the nature of the cause of action for which the suit is brought", in other words "Whether an action survives depends on the substance of the cause of action, not on the forms of proceeding to enforce it."

We are not therefore concerned with whether liability for the 50 per centum addition to tax deficiencies imposed for fraud by the section under consideration is enforceable by criminal or by civil proceedings, i. e., whether the sanction imposed by the statute is civil or criminal, either of which Congress clearly has the power to impose. *Oceanic Navigation Co. v. Stranahan,* 214 U.S. 320, 339. Our basic question is whether the fraud addition is a

[2] § 293(b) "Fraud. If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid. . . ."

money penalty, however it may be enforceable, and this, of course, poses a question of Congressional intent, for if Congress intended the addition as a penalty, it is clear from the authorities that liability therefor does not survive.

The petitioner makes a plausible, even a forceful, argument for the proposition that the fraud addition was intended by Congress as a personal punishment for taxpayers guilty of fraud on the revenue. We see no reason to consider the argument, however, for it seems to us that the Supreme Court in the course of deciding *Helvering v. Mitchell,* 303 U.S. 391, clearly characterized the fraud assessment as not penal, but compensatory to the government to recompense it for the loss and expense occasioned by frauds perpetrated upon its revenue.

In the *Mitchell* case it appeared that the taxpayer had been acquitted on an indictment charging him under § 146(b) of the Revenue Act of 1928 with the crime of willfully attempting to evade and defeat his income tax, and the question presented was whether that acquittal barred an assessment resting on the same facts as the indictment of the 50 per centum addition for fraud imposed by § 293(b) of the same Revenue Act, which, so far as material, is identical in language with the same section of the subsequent Revenue Acts and of the Internal Revenue Code under consideration here. The Supreme Court answered the question in the negative, holding that neither the doctrine of res judicata nor the double jeopardy provision of the Constitution operated to make the acquittal a bar to the assessment.

Thus it is true, as the petitioner emphasizes, that the *Mitchell* case raises no question of the survival of the statutory assessment for fraud. Moreover, it is also true that it was only necessary to the decision of the issues raised in that case for the Supreme Court to hold that the fraud assessment was not intended by Congress as a criminal penalty—the question whether it was intended to be a civil penalty, that is, an exaction in the way of punishment enforceable in a civil action, not being involved. But the court in the course of holding that the assessment was not a criminal penalty, went further and said that the assessment was not a penalty at all, stating categorically that "The remedial character of sanctions imposing additions to a tax has been made clear by this Court in passing upon similar legislation. They are provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud." And, following this, it said, quoting *Stockwell v. United States,* 13 Wall. 531, 547, 551, "It must therefore be considered as remedial, as providing indemnity for loss."

No doubt the 50 per centum addition operates in some measure to punish taxpayers for their fraud on the revenue. No

doubt also it has a deterrent effect upon those who would consider the perpetration of such a fraud. But in the face of the language of the Supreme Court in the *Mitchell* case, we do not feel at liberty to characterize the fraud addition as anything but remedial. In short, we agree with the interpretation placed on the decision in the *Mitchell* case by the Tax Court in the case at bar and in *Estate of Reimer v. Commissioner*, 12 T.C.No. 121. To the same effect, although collaterally, see also *Bowles v. Farmers Nat. Bank of Lebanon, Ky.*, 147 F.2 425.

And our conclusion that the statutory addition for fraud was intended to be remedial rather than punitive disposes of the case at bar. For even though, as the petitioner contends, the early law was that the only actions ex delicto which could be prosecuted against the estate of a decedent were those wherein the plaintiff sought to recover property, or the proceeds or value of property, appropriated by the decedent and added to his estate (*United States v. Daniel et al.*, 6 How. 11, 13; *Henshaw v. Miller*, 17 How. 211; *Iron Gate Bank v. Brady*, 184 U.S. 665; see also *Sullivan v. Associated Billposters and Distributors*, [6 F.2d 1000], 1002–1008, and cases cited), under which liability for the tax deficiency could be said to survive but liability for the fraud addition thereto could not, we are satisfied that the modern rule as to the survival of tort actions against decedents' estates is that although actions to recover penalties do not survive, actions to recover compensation for monetary losses or injuries inflicted by a decedent do, without regard to any enrichment of the decedent's estate. . . .

It is to be carefully observed that we are not here concerned with any question of the survival, under general legal principles, of liability for damages awarded primarily as balm for injured feelings in causes of action for libel, slander, malicious prosecution, alienation of affections and the like. Our sole concern is with the survival of liability for damages awarded to reimburse for expense and loss, and our conclusion is that under modern principles of law liability for damages of this sort survives the death of the person liable regardless of whether or not his estate has been enriched.

The decision of the Tax Court is affirmed.

Note

On a joint return, the liability is joint and several (sec. 6013 (d) (3) of the 1954 Code), and this applies to penalties as well as to the tax. *Boyett v. Commissioner*, 204 F.2d 205 (C.A.5th, 1953); *Howell v. Commissioner*, 175 F.2d 240 (C.A.6th, 1949). In *Kann v. Commissioner*, 210 F.2d 247 (C.A.3d, 1953), the wife was held liable for penalties resulting from her husband's fraud,

where the Tax Court found a joint return had been filed, even though she had not signed the return or filed a power of attorney authorizing her husband to sign for her.

SPIES v. UNITED STATES

Supreme Court of the United States, 1943. 317 U.S. 492.

MR. JUSTICE JACKSON delivered the opinion of the Court.

Petitioner has been convicted of attempting to defeat and evade income tax in violation of § 145(b) of the Revenue Act of 1936, 49 Stat. 1648, 1703, now § 145(b) of the Internal Revenue Code. The Circuit Court of Appeals found the assignment of error directed to the charge to the jury the only one of importance enough to notice. The charge followed the interpretation put upon this section of the statute in *O'Brien v. United States*, 51 F. 2d 193 (C.C.A. 7), and *United States v. Miro*, 60 F.2d 58 (C.C. A. 2), which followed it. The Circuit Court of Appeals affirmed, stating that "we must continue so to construe the section until the Supreme Court decides otherwise." 128 F.2d 743. One Judge said that as a new matter he would decide otherwise and expressed approval of the dissent in the *O'Brien* case. As the construction of the section raises an important question of federal law not passed on by this Court, we granted certiorari.

Petitioner admitted at the opening of the trial that he had sufficient income during the year in question to place him under a statutory duty to file a return and to pay a tax, and that he failed to do either. The evidence during nearly two weeks of trial was directed principally toward establishing the exact amount of the tax and the manner of receiving and handling income and accounting, which the Government contends shows an intent to evade and defeat tax. Petitioner's testimony related to his good character, his physical illness at the time the return became due, and lack of willfulness in his defaults, chiefly because of a psychological disturbance, amounting to something more than worry but something less than insanity.

Section 145(a) makes, among other things, willful failure to pay a tax or make a return by one having petitioner's income at the time or times required by law a misdemeanor.[1] Section 145 (b) makes a willful attempt in any manner to evade or defeat

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1 "Any person required under this title to pay any tax, or required by law or regulations made under authority thereof to make a return, keep any records, or supply any information, for the purposes of the computation, assessment, or collection of any tax imposed by this title, who willfully fails to pay such tax, make such return, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than one year, or both, together with the costs of prosecution."

any tax such as his a felony.[2] Petitioner was not indicted for either misdemeanor. The indictment contained a single count setting forth the felony charge of wilfully attempting to defeat and evade the tax, and recited willful failure to file a return and willful failure to pay the tax as the means to the felonious end.

The petitioner requested an instruction that "You may not find the defendant guilty of a willful attempt to defeat and evade the income tax, if you find only that he had wilfully failed to make a return of taxable income and has wilfully failed to pay the tax on that income." This was refused, and the Court charged that "If you find that the defendant had a net income for 1936 upon which some income tax was due, and I believe that is conceded, if you find that the defendant wilfully failed to file an income tax return for that year, if you find that the defendant wilfully failed to pay the tax due on his income for that year, you may, if you find that the facts and circumstances warrant it find that the defendant wilfully attempted to evade or defeat the tax." The Court refused a request to instruct that an affirmative act was necessary to constitute a willful attempt and charged that "Attempt means to try to do or accomplish. In order to find an attempt it is not necessary to find affirmative steps to accomplish the prohibited purpose. An attempt may be found on the basis of inactivity or on refraining to act, as well."

It is the Government's contention that a willful failure to file a return together with a willful failure to pay the tax may, without more, constitute an attempt to defeat or evade a tax within § 145(b). Petitioner claims that such proof establishes only two misdemeanors under § 145(a) and that it takes more than the sum of two such misdemeanors to make the felony under § 145 (b). The legislative history of the section contains nothing helpful on the question here at issue, and we must find the answer from the section itself and its context in the revenue laws.

The United States has relied for the collection of its income tax largely upon the taxpayer's own disclosures rather than upon a system of withholding the tax from him by those from whom income may be received. This system can function successfully only if those within and near taxable income keep and render true accounts. In many ways taxpayers' neglect or deceit may prejudice the orderly and punctual administration of the system as

2 "Any person required under this title to collect, account for, and pay over any tax imposed by this title, who willfully fails to collect or truthfully account for and pay over such tax, and any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than five years, or both, together with the costs of prosecution."

well as the revenues themselves. Congress has imposed a variety of sanctions for the protection of the system and the revenues. The relation of the offense of which this petitioner has been convicted to other and lesser revenue offenses appears more clearly from its position in this structure of sanctions.

The penalties imposed by Congress to enforce the tax laws embrace both civil and criminal sanctions. The former consist of additions to the tax upon determinations of fact made by an administrative agency and with no burden on the Government to prove its case upon a reasonable doubt. The latter consist of penal offenses enforced by the criminal process in the familiar manner. Invocation of one does not exclude resort to the other. *Helvering v. Mitchell*, 303 U.S. 391.

The failure in a duty to make a timely return, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, is punishable by an addition to the tax of 5 to 25 per cent thereof, depending on the duration of the default. § 291 of the Revenue Act of 1936 and of the Internal Revenue Code. But a duty may exist even when there is no tax liability to serve as a base for application of a percentage delinquency penalty; the default may relate to matters not identifiable with tax for a particular period; and the offense may be more grievous than a case for civil penalty. Hence the willful failure to make a return, keep records, or supply information when required, is made a misdemeanor, without regard to existence of a tax liability. § 145 (a). Punctuality is important to the fiscal system, and these are sanctions to assure punctual as well as faithful performance of these duties.

Sanctions to insure payment of the tax are even more varied to meet the variety of causes of default. It is the right as well as the interest of the taxpayer to limit his admission of liability to the amount he actually owes. But the law is complicated, accounting treatment of various items raises problems of great complexity, and innocent errors are numerous, as appear from the number who make overpayments.[3] It is not the purpose of the law to penalize frank difference of opinion or innocent errors made despite the exercise of reasonable care. Such errors are corrected by the assessment of the deficiency of tax and its col-

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3 The following statistics are given by the Commissioner of Internal Revenue for the fiscal year 1941: 73,627 certificates of overassessment of income tax issued, for 39,730 of which no claims had been filed; 236,610 assessments of additional income taxes made; 871 investigations made of alleged evasion of income and miscellaneous taxes, with recommendation for prosecution in 239 cases involving 446 individuals, of whom 192 were tried and 156 convicted. The total number of income tax returns filed was 16,052,007, of which number 7,867,319 reported a tax. Annual Report of the Commissioner of Internal Revenue (1941), pp. 17, 20, 21, 22, 52, 108.

lection with interest for the delay. §§ 292 and 294 of the Revenue Act of 1936 and of the Internal Revenue Code. If any part of the deficiency is due to negligence or intentional disregard of rules and regulations, but without intent to defraud, five per cent of such deficiency is added thereto; and if any part of any deficiency is due to fraud with intent to evade tax, the addition is 50 per cent thereof. § 293 of the Revenue Act of 1936 and of the Internal Revenue Code. Willful failure to pay the tax when due is punishable as a misdemeanor. § 145(a). The climax of this variety of sanctions is the serious and inclusive felony defined to consist of willful attempt in any manner to evade or defeat the tax. § 145(b). The question here is whether there is a distinction between the acts necessary to make out the felony and those which may make out the misdemeanor.

A felony may, and frequently does, include lesser offenses in combination either with each other or with other elements. We think it clear that this felony may include one or several of the other offenses against the revenue laws. But it would be unusual and we would not readily assume that Congress by the felony defined in § 145(b) meant no more than the same derelictions it had just defined in § 145(a) as a misdemeanor. Such an interpretation becomes even more difficult to accept when we consider this felony as the capstone of a system of sanctions which singly or in combination were calculated to induce prompt and forthright fulfillment of every duty under the income tax law and to provide a penalty suitable to every degree of delinquency.

The difference between willful failure to pay a tax when due, which is made a misdemeanor, and willful attempt to defeat and evade one, which is made a felony, is not easy to detect or define. Both must be willful, and willful, as we have said, is a word of many meanings, its construction often being influenced by its context. *United States v. Murdock*, 290 U.S. 389. It may well mean something more as applied to nonpayment of a tax than when applied to failure to make a return. Mere voluntary and purposeful, as distinguished from accidental, omission to make a timely return might meet the test of willfulness. But in view of our traditional aversion to imprisonment for debt, we would not without the clearest manifestation of Congressional intent assume that mere knowing and intentional default in payment of a tax where there had been no willful failure to disclose the liability is intended to constitute a criminal offense of any degree. We would expect willfulness in such a case to include some element of evil motive and want of justification in view of all the financial circumstances of the taxpayer.

Had § 145(a) not included willful failure to pay a tax, it would have defined as misdemeanors generally a failure to observe

statutory duties to make timely returns, keep records, or supply information—duties imposed to facilitate administration of the Act even if, because of insufficient net income, there were no duty to pay a tax. It would then be a permissible and perhaps an appropriate construction of § 145(b) that it made felonies of the same willful omissions when there was the added element of duty to pay a tax. The definition of such nonpayment as a misdemeanor we think argues strongly against such an interpretation.

The difference between the two offenses, it seems to us, is found in the affirmative action implied from the term "attempt," as used in the felony subsection. It is not necessary to involve this subject with the complexities of the common-law "attempt".[4] The attempt made criminal by this statute does not consist of conduct that would culminate in a more serious crime but for some impossibility of completion or interruption or frustration. This is an independent crime, complete in its most serious form when the attempt is complete and nothing is added to its criminality by success or consummation, as would be the case, say, of attempted murder. Although the attempt succeed in evading the tax, there is no criminal offense of that kind, and the prosecution can be only for the attempt. We think that in employing the terminology of attempt to embrace the gravest of offenses against the revenues Congress intended some willful commission in addition to the willful omissions that make up the list of misdemeanors. Willful but passive neglect of the statutory duty may constitute the lesser offense, but to combine with it a willful and positive attempt to exade tax in any manner or to defeat it by any means lifts the offense to the degree of felony.

Congress did not define or limit the methods by which a willful attempt to defeat and evade might be accomplished and perhaps did not define lest its effort to do so result in some unexpected limitation. Nor would we by definition constrict the scope of the Congressional provision that it may be accomplished "in any manner." By way of illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal. If the tax-evasion motive plays any part in such conduct the offense may be

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4 Holmes, The Common Law, pp. 65–70; Hall, Criminal Attempt—A Study of Foundations of Criminal Liability, 49 Yale Law Journal 789; Arnold, Criminal Attempts—The Rise and Fall of an Abstraction, 40 Yale Law Journal 53.

made out even though the conduct may also serve other purposes such as concealment of other crime.

In this case there are several items of evidence apart from the default in filing the return and paying the tax which the Government claims will support an inference of willful attempt to evade or defeat the tax. These go to establish that petitioner insisted that certain income be paid to him in cash, transferred it to his own bank by armored car, deposited it, not in his own name but in the names of others of his family, and kept inadequate and misleading records. Petitioner claims other motives animated him in these matters. We intimate no opinion. Such inferences are for the jury. If on proper submission the jury found these acts, taken together with willful failure to file a return and willful failure to pay the tax, to constitute a willful attempt to defeat and evade tax, we would consider conviction of a felony sustainable. But we think a defendant is entitled to a charge which will point out the necessity for such an inference of willful attempt to defeat or evade tax from some proof in the case other than that necessary to make out the misdemeanors; and if the evidence fails to afford such an inference, the defendant should be acquitted.

The Government argues against this construction, contending that the milder punishment of a misdemeanor and the benefits of a short statute of limitations should not be extended to violators of the income tax laws such as political grafters, gamblers, racketeers, and gangsters. We doubt that this construction will handicap prosecution for felony of such flagrant violators. Few of them, we think, in their efforts to escape tax stop with mere omission of the duties put upon them by the statute, but if such there be, they are entitled to be convicted only of the offense which they have committed.

Reversed.

Notes

(A) Note the period of limitations on prosecutions in sec. 6531 of the 1954 Code. See also the "Miscellaneous Title," at the end of the 1954 Code. See Carrigan, "Tax Crimes—Statutes of Limitations—Tolling Provisions," 11 Tax L.Rev. 137 (1956).

(B) For discussions of questions in criminal tax cases, see Schmidt, "Corroboration of Admissions in Criminal Income Tax Prosecutions," 37 U. of Detroit L.Rev. 173 (1959); Murphy, "The Investigative Procedure for Criminal Tax Evasion," 27 Fordham L.Rev. 48 (1958); Mills, "The Net Worth Approach in Determining Income," 41 Va.L.Rev. 927 (1955); Gilman, "Current Problems in Criminal Tax Fraud," 33 Taxes 749 (1955).[1]

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[1] For earlier treatment, see Avakian, "Net Worth Computation as Proof of Tax Evasion," 10 Tax L.Rev. 431 (1955); Burns and Rachlin, "Trial by Net Worth," 33 Taxes 121 (1955); Lyon, "The Crime of Income Tax Fraud: Its

(C) *United States v. Carroll,* 345 U.S. 457 (1953), involved an indictment for failing to file information returns under what is now sec. 7203 of the 1954 Code. The indictment contained 101 counts, each of which related to a named individual, and charged wilful failure to make a return on Treasury Form 1099 giving information of the payment. The regulations required a return on Form 1099 as to each payee, accompanied by a transmittal form on Form 1096. The only form that is signed is Form 1096.

The Court held that the return referred to in the provision now found in secs. 6041 and 7203 of the 1954 Code is that on Form 1096, and that since the only offenses charged in the 101 counts of the indictment were failures to file Form 1099 the indictment should be dismissed. In the Court's view the Forms 1099 were in effect schedules to Form 1096, and the latter was "the return" referred to in the statute.

Present Status and Function," 53 Col.L.Rev. 476 (1953); Murphy, "Criminal Tax Evasion," 48 Northwestern U.L.Rev. 317 (1953); Leake, "Felonies under Section 145(b) and the Statute of Limitations," 30 Taxes 786 (1952); Lipton, "Prosecutions for Tax Evasion—New Policies and Procedure," 30 Taxes 350 (1952); Frazier, "Is a Voluntary Disclosure a Legal Defense to a Criminal Prosecution?" 28 Taxes 1071 (1950); Rothwacks, "Law and Procedure in Criminal Tax Prosecutions," 26 Taxes 797 (1948). Many of the criminal provisions under the federal income tax are reviewed in Puttkammer and Sears, "Criminal Aspects of an Income Tax Strike," 2 U. of Chi.L.Rev. 14 (1934).

TABLE OF CORRESPONDING SECTIONS—1939 TO 1954 CODE

This Table lists the sections of the Internal Revenue Code of 1939, as amended, 26 U.S.C.A., and indicates the sections of the Internal Revenue Code of 1954 which cover similar subject matter.

Former 26 U.S.C.A. 1939 Code Sec.	Present 26 U.S.C.A. 1954 Code Sec.
1	Omitted
2	7806(a)
3	Omitted
4	Omitted
11	1
12(a)	Omitted
12(b) (1), (2)	Omitted
12(b) (3)	1
12(c)	1
12(d)	2
12(e)	Omitted
12(f)	1
12(g)	Omitted
13(a)	Omitted
13(b)	11
13(c)–(f)	Omitted
14	Omitted
15(a), (b)	11
15(c)	1551
21	63
22(a)	61
22(b) (1)	101
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22(b) (2) (B)	72, 403
22(b) (2) (C)	72
22(b) (3)	102
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22(b) (6)	107
22(b) (7)	894
22(b) (8)	115, 526, 892, 893, 911, 912, 933, 943
22(b) (9)	108
22(b) (10)	108
22(b) (11)	109
22(b) (12)	111
22(b) (13)	112
22(b) (14)	113
22(b) (15)	621
22(b) (16)	114
22(c)	471
22(d) (1)–(5)	472
22(d) (6)	1321, 6155(a)
22(e)	301(a)
22(f)	1001
22(g)	861, 862, 863, 864
22(h)	Chapter 1, Subchapter G, Part III
22(i)	Omitted
22(j)	76
22(k)	71
22(*l*)	691
22(m)	73, 6201(c)
22(n)	62
22(*o*)	75
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23(a) (1) (A)	162
23(a) (1) (B)	162
23(a) (1) (C)	263
23(a) (2)	212
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23(c) (1)	164
23(c) (2)	Omitted
23(c) (3)	164
23(d)	164
23(e)	165
23(f)	165
23(g)	165
23(h)	165
23(i)	165
23(j)	1091
23(k) (1)	166, 593
23(k) (2)	165(g) (1), 166(e), 582
23(k) (3)	165(g) (2)
23(k) (4)	166
23(k) (5)	166
23(k) (6)	271, 166
23(*l*)	167
23(m)	611

Former 26 U.S.C.A. 1939 Code Sec.	Present 26 U.S.C.A. 1954 Code Sec.
23(n)	167
23(o)	170
23(p)	404
23(q)	170
23(r)	591
23(s)	172
23(t)	168, 169
23(u)	215
23(v)	171
23(w)	691
23(x)	213
23(y)	Omitted
23(z)	216
23(aa) (1)	141
23(aa) (2)	36
23(aa) (3)	144
23(aa) (4)	4, 142
23(aa) (5)	142
23(aa) (6)	143
23(aa) (7)	144
23(bb)	173
23(cc)	616
23(dd)	592
23(ee)	1202
23(ff)	615
24(a)	261
24(a) (1)	262
24(a) (2), (3)	263
24(a) (4)	264
24(a) (5)	265
24(a) (6)	264
24(a) (7)	266
24(b)	267
24(c)	267
24(d)	273
24(e)	1451
24(f)	268
25(a)	35
25(b) (1)	151
25(b) (2)	153
25(b) (3)	152
26	241
26(a)	242
26(b)	246
26(b) (1)	243
26(b) (2)	244
26(b) (3)	245
26(c)	545, 556
26(d)	535, 545, 601
26(e)	Omitted
26(f)	561, 562, 564
26(g)	565
26(h)	247
26(i)	922
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